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Advisor alert—*Get ready for IFRS 15 – Recognising revenue in the real estate and construction industries*

September 2016

Overview

The Grant Thornton International Ltd IFRS Team has published *Get ready for IFRS 15 – Recognising revenue in the real estate and construction industries*, a more detailed look at the issues facing companies operating in the real estate and construction industries as they get ready to adopt IFRS 15 *Revenue from Contracts with Customers*.

For companies with real estate development, property management or construction activities, IFRS 15 replaces several familiar standards and provides significant new guidance in a number of key areas.

Filled with practical insights and examples, this publication offers companies operating in the real estate and construction industries helpful guidance in identifying and responding to the most significant impacts of IFRS 15.

Resource

The publication *Get ready for IFRS 15 – Recognising revenue in the real estate and construction industries* follows this *Advisor alert*.

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The information in this publication is current as of September 14, 2016.

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Get ready for IFRS 15

Recognising revenue in the real estate and construction industries

The IASB and FASB have issued their new Standard on revenue recognition – IFRS 15 'Revenue from Contracts with Customers' (ASU 2014-09 in the US). For companies with real estate development, property management or construction activities, IFRS 15 replaces several familiar standards and provides significant new guidance in a number of key areas.

Filled with practical insights and examples, this publication offers companies operating in the real estate and construction industries helpful guidance in identifying and responding to the most significant impacts of the new Standard.

Issue 1 August 2016

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About us

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1. Introduction

In May 2014, the International Accounting Standards Board (IASB) and US FASB issued their new Standard on revenue – IFRS 15 'Revenue from Contracts with Customers' (ASU 2014-09 in the US).

For companies with real estate development, property management or construction activities (the "real estate and construction industries"), the new guidance replaces several familiar standards including IAS 18 'Revenue', IAS 11 'Construction Contracts' and IFRIC 15 'Agreements for the Construction of Real Estate'.

In return, the new Standard provides significant new guidance addressing key questions such as:

- Should revenue be recognised over time, or only upon completion?
- How will revenue recognition be impacted when a seller finances its customer's purchase?
- What impact will contract modifications (ie 'change orders' or 'variations') have on current and future revenues?
- How should performance-based fees be accounted for?
- When a developer intends to make a claim for cost overruns caused by a customer delay, what impact will this have on current period revenues?
- Can mobilisation and contract acquisition costs be capitalised, or must they be expensed?
- When do bundled goods or services represent separate performance obligations?

IFRS 15 abandons the former risks and rewards-based approach in favour of a new control-based model built around the following five steps.

The new Standard changes the criteria for determining whether revenue is recognised at a point in time or over time and companies will need to consider their contracts carefully. Disclosures about revenue are also expanded and improved and now include information about contract balances and changes, remaining performance obligations (backlog), and key judgements around the timing of and methods used for recognising revenue.

Practical insight – The big picture

Accounting for revenue in the real estate and construction industries involves unique challenges, from dealing with complex bundles of interrelated goods and services to vendor guarantees, 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.

IFRS 15's control-based 5-step model

1. Identify the contract with the customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognise revenue

Companies are required to apply IFRS 15 to their annual reporting periods beginning on or after 1 January 2018 although early application is permitted. With the potential to significantly impact the timing and amount of revenue recognised, entities in the real estate and construction industries will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.

2. In more detail

Scope

IFRS 15 applies to contracts with customers to provide goods or services. It does not apply to certain contracts within the scope of other IFRSs such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees (other than product warranties), and non-monetary exchanges between entities in the same line of business to facilitate sales to third-party customers.

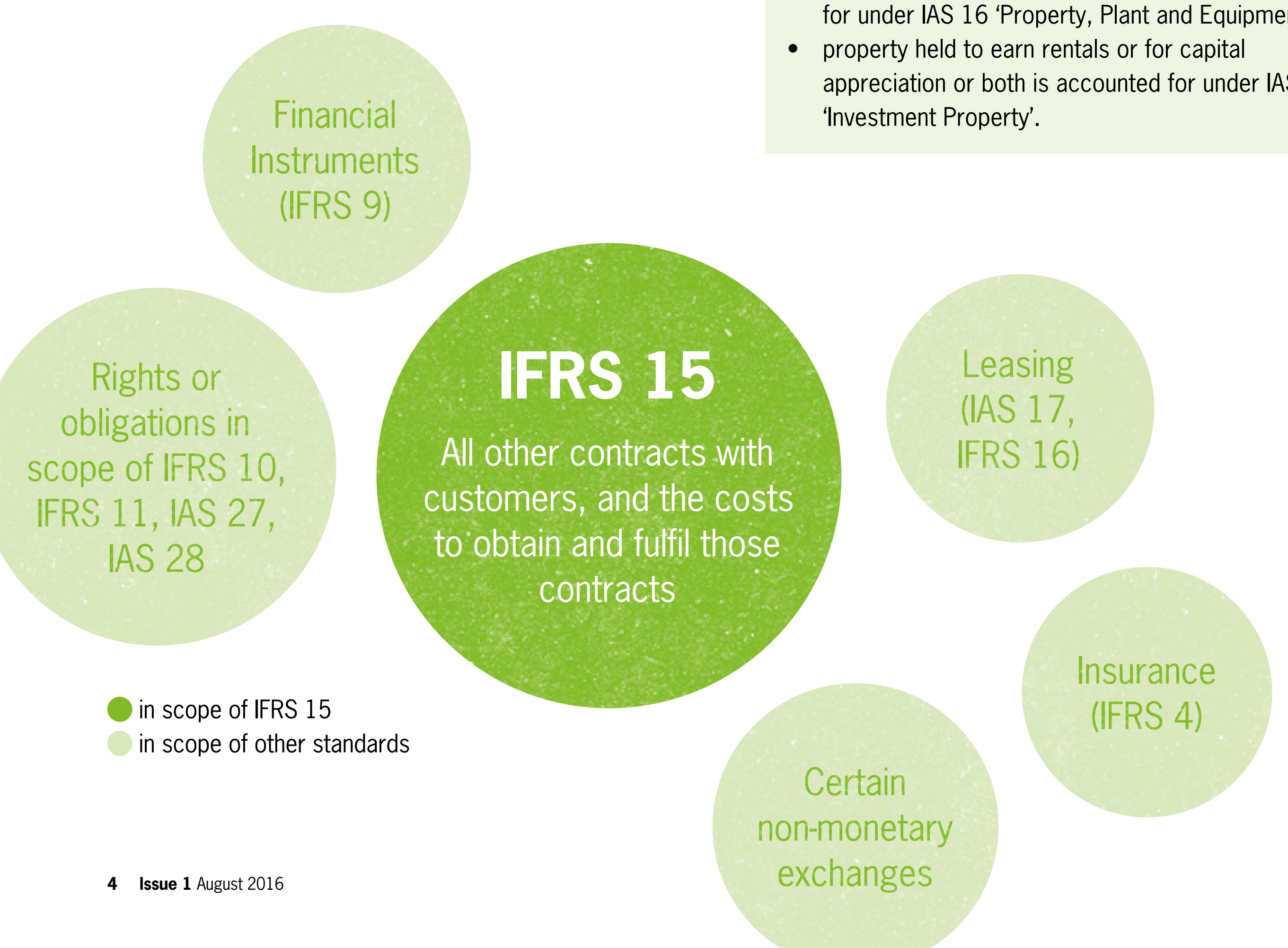
Even after a customer contract is determined to be in scope, there are a number of additional 'gating' criteria to be met before the detailed guidance in IFRS 15 can be applied. These include:

- the contract has commercial substance
- the parties have approved the contract
- each party's rights and the payment terms can be identified
- it is probable the company will collect the consideration to which it will be entitled.

Practical insight – Real estate investors

For real estate investors, accounting for an acquired property (land or building or both) and its subsequent disposition depends on the investor's intentions:

- property intended for sale in the ordinary course of business is accounted for under IAS 2 'Inventories', and its subsequent sale under IFRS 15 'Revenue from Contracts with Customers'
- owner-occupied property (including property held for future use as owner-occupied property) is accounted for under IAS 16 'Property, Plant and Equipment'
- property held to earn rentals or for capital appreciation or both is accounted for under IAS 40 'Investment Property'.



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

- performance is complete and substantially all the consideration promised by the customer has been received and is non-refundable, or
- the arrangement has been cancelled and any consideration received is non-refundable.

For companies in the real estate and construction industries, the collectability criterion noted above takes on added significance when the seller finances the purchase of real estate. In making its assessment of collectability a company considers only the buyer's ability and intention to pay the consideration when it is due. This could include assessing the creditworthiness of the buyer, and determining whether the customer has other income or assets that could be used to repay the loan and whether the seller-lender has recourse to those other assets. If collection is not considered probable, then the detailed revenue recognition guidance in IFRS 15 is 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 companies.

Example 1 – Vendor financing with collectability concerns

A real estate developer enters into a contract with an individual for the sale of a small retail-oriented building for CU500,000. The customer is required to pay a deposit of only CU50,000 and enters into a long-term financing arrangement with the developer for the remainder of the purchase price. In the event of default, the developer has the right to repossess the building, but no ability to enforce collection against any of the customer's other assets, which are minimal. Upon signing the contract, the customer obtains immediate control of the property in which he plans to operate a comic book store. The building is located in the city's business district which has little foot traffic during evenings and weekends. While the customer has collected comic books as a hobby for many years, he has no direct retail experience, no significant collateral, and no other sources of income at this time.

The developer considers the criteria in IFRS 15.9 and concludes that, at inception, it is not probable that it will be successful in collecting all the consideration to which it is entitled because:

a) the customer's ability to repay the loan depends on the success of the planned retail operation in which they have no relevant experience, and
b) the customer has no other income or assets that could be used to repay the loan.

As a result, at inception of the contract the developer is required to recognise the CU50,000 as a deposit liability. This continues until either the criteria are met, or until one of the previously described cancellation- or completion-related conditions occurs. Until that time, the developer is unable to apply the IFRS 15 model and recognises no revenue.

Note that if the developer intends to offer a price concession to the customer, then the amount the developer will be entitled to is less than the amount stated in the contract, and the additional 'gating' criteria are assessed against the lower amount. Under the circumstances described above, a concession is unlikely to change the outcome of the analysis.

Core principles

IFRS 15 is based on a core principle requiring a company to recognise revenue in a way that reflects the pattern in which goods or services are transferred to customers, at an amount that reflects the consideration the company expects to be entitled to in exchange for those goods or services.

Putting this principle into practice involves the following five steps:

- identifying the contract(s) with a customer
- identifying the performance obligations
- determining the transaction price
- allocating the transaction price to the performance obligations
- recognising revenue as (or when) performance occurs

We will deal with each of the steps in more detail below.

The first step in IFRS 15 is to identify the 'contract', which IFRS 15 defines as "an agreement between two or more parties that creates enforceable rights and obligations".

Step 1: Identifying the contract with a customer

The first step in IFRS 15 is to identify the 'contract', which IFRS 15 defines as "an agreement between two or more parties that creates enforceable rights and obligations".

A contract can be written, oral or implied by a company's customary business practices. A contract does not exist if each party has a unilateral right to terminate a wholly unperformed contract without compensating the other party. A customer is a party that contracts with a company to obtain goods or services that are an output of its ordinary activities.

Combining contracts

IAS 11 includes some guidance on when two or more contracts should be combined, focusing on how the group of contracts was negotiated, the extent of any interrelationships between them, and whether they are performed concurrently. There is new language to consider under IFRS 15, but the underlying principles are similar. Under IFRS 15, a company is required to combine two or more contracts and account for them as a single contract if they are entered into at or near the same time and meet one of the following criteria:

- the contracts were negotiated as a package with one commercial objective
- the amount paid under one contract is dependent on the price or performance under another contract
- the goods or services to be transferred under the contracts constitute a single performance obligation.

As a result, we do not expect that current practice will change significantly in this area.

Example 2 – Collaborative arrangements

Company A enters into a one-off arrangement with Company B to co-develop a warehouse. Assume that Company A's ordinary activities do not include the construction of buildings for sale to its customers. Upon completion of the project, each party will receive a 50% interest in the building. Company A provides the labour and procurement services and Company B provides the cash needed to pay for the concrete, steel, and other materials. While there is always the potential to look at this transaction as the sale of a portion of the warehouse in exchange for cash, the development of assets under collaborative arrangements are outside the scope of IFRS 15. In this situation B would not be a customer of A.

Diagram 1 – Combining multiple legal contracts with the same entity for accounting purposes

Single contract for IFRS 15 purposes

Example 3 – Combining contracts

Company A enters into an agreement with a customer for the sale of land for CU1 million. At the same meeting with the same representatives present, Company A enters into a second agreement with the same customer to construct a building on that land for an additional CU500,000.

The contracts should be combined. The two contracts were entered into at or near the same time and appear to have been negotiated as a package with a single commercial objective in mind. As a result, the IFRS 15 model must be applied to identify the separate performance obligations contained within the combined contract and to allocate the total consideration among them. In most cases this will result in changes to the timing of revenue recognition.

The allocation principles in IFRS 15 (see Step 4) cannot be circumvented by the use of multiple contracts.

Segmenting contracts

While IFRS 15 does not provide any guidance specifically addressing the segmentation of individual contracts, it does provide detailed guidance concerning when the individual promises in a contract need to be accounted for as separate performance obligations. While most companies in the real estate and construction industries are unlikely to see significant changes in this area, the segmentation criteria in IAS 11 are different than the relevant criteria in IFRS 15, and all contracts will need to be carefully assessed using the new guidance. The identification of separate performance obligations within a contract is covered in greater detail in Step 2 below.

Contracts with vendor repurchase rights or obligations

Under current guidance, a seller's right (call option) or obligation (forward or put option) to repurchase property (or any other good) from the buyer must be carefully analysed to ascertain whether the significant risks and rewards have been transferred to the original 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 specific nature of the seller's right or obligation (eg forward, seller's call option or buyer's put option), the relationship between the repurchase price and the original selling price, and, in some 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 fall outside of IFRS 15 and be accounted for as a lease or financing arrangement.

While IFRS 15 does not provide any guidance specifically addressing the segmentation of individual contracts, it does provide detailed guidance concerning when the individual promises in a contract need to be accounted for as separate performance obligations.

Step 2: Identifying the performance obligations

Having identified a contract, a company will need to identify the performance obligations within that contract.

For example, a developer may sell land with a commitment to then design and build a shopping centre on it. The company will need to use the new guidance to evaluate whether the land sale, design, and construction elements represent separate performance obligations or a single performance obligation. In contrast, existing standards provide almost no guidance on how to identify the separate components of a transaction.

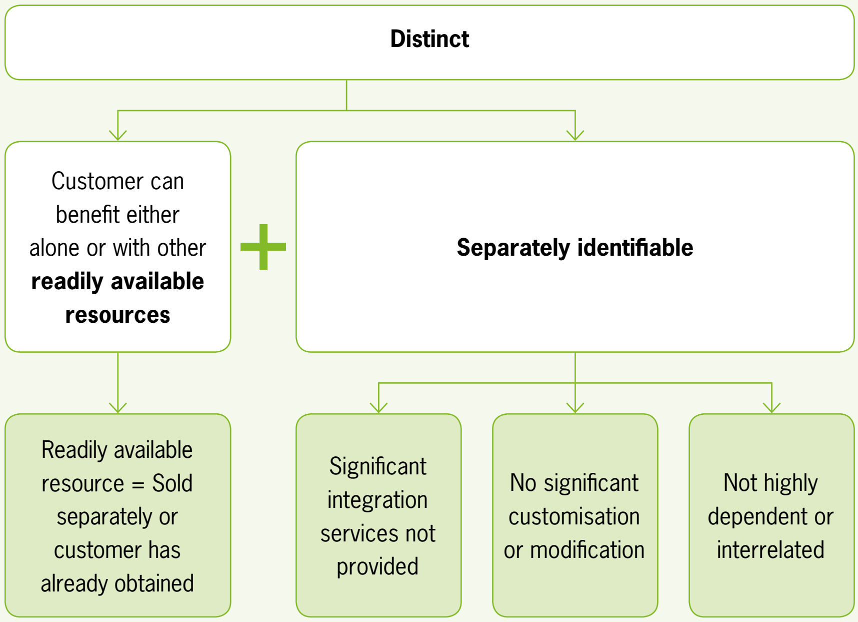
Under IFRS 15, a performance obligation is a promise in a contract with a customer to transfer either (1) a good or service, or a bundle of goods or services, that is 'distinct', or (2) a series of distinct goods or services that are substantially the same and meet certain criteria.

A promised good or service is 'distinct' if both:

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

A readily available resource is a good or service that is sold separately (either by the company or by someone else) or that the customer has already obtained.

Diagram 2 – Meaning of 'distinct'



Indicators that a promise is 'separately identifiable' include:

- Significant integration services are not provided, ie the good or service must not be used solely as an input to produce the output called for in the contract. As an example of this consider a contract for the sale of a building in which the seller is required to procure all the necessary materials including metal beams, roofing materials, screws, bolts, nails, flooring, and other elements common to a building. The seller also provides the labour and expertise required to assemble all those parts into the completed building. In this example, the materials needed to construct the building are not considered to be separately identifiable because they are subject to significant integration services. Put another way, the contract is for the sale of a completed building, not the separate sale of parts and labour as distinct deliverables in their own right.
- The good or service does not significantly modify or customise other promised goods or services in the contract. Where, for example, a company agrees to modify an apartment by installing a new kitchen and replacing the flooring before control over the apartment transfers to the buyer, those services are not considered to be separately identifiable from the sale of the apartment itself.
- The good or service is not highly dependent on, or interrelated with, other promised goods or services in the contract.

Performance obligations are normally specified in the contract but also include promises implied by a company's customary business practices, published policies or specific statements that create a valid customer expectation that goods or services will be transferred under the contract.

Example 4 – Identifying distinct performance obligations

A construction services company enters into a contract with a customer to build a water purification plant. The company is responsible for all aspects of the build including overall project management, engineering and design services, site preparation, physical construction of the plant, procurement of pumps and equipment for measuring and testing flow volumes and water quality, and the integration of all components. Determining whether a good or service represents a performance obligation on its own or is required to be aggregated with other goods or services can have a significant impact on the timing of revenue recognition.

In order to determine how many performance obligations are present in the contract, the company applies the guidance above. While the customer may be able to benefit from each promised good or service on its own (or together with other readily available resources), they do not appear to be separately identifiable within the context of the contract. That is, the promised goods and services are subject to significant integration, and as a result will be treated as a single performance obligation. This is consistent with a view that the customer is primarily interested in acquiring a single asset (a water purification plant) rather than a collection of related components and services.

Performance obligations do not include administrative-type tasks that do not result in a transfer of a good or service to a customer, regardless of how necessary they are (eg some kinds of set-up or mobilisation activities).

Practical insight – What does a performance obligation look like?

A performance obligation is easy to identify – most of the time. When a contract simply states that a company will sell Apartment #15 to its customer, we expect that Apartment #15 is going to be a performance obligation. But some performance obligations can be harder to spot. As already noted, a performance obligation does not have to be stated in the contract. Some performance obligations can be implied by past behaviour creating a valid expectation of performance in the mind of a customer. In addition, stand-ready obligations (eg a promise to clear snow from a shopping mall parking lot when and if it snows) and coupons for significant and incremental discounts off future purchases (where the coupons represent a 'material right' granted to the customer) can also be performance obligations.

In light of the significant new guidance provided, companies applying IFRSs will need to analyse all but the simplest customer contracts to determine whether they include more than one performance obligation, based on the 'distinct' principle described above. That said, we expect that many long-term construction and service contracts will be identified as single performance obligations because they often include a significant integration service.

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Step 3: Determining the transaction price

Under IFRS 15, the 'transaction price' is defined as the amount of consideration a company expects to be entitled to in exchange for the goods or services promised under a contract, excluding any amounts collected on behalf of third parties (for example, sales taxes). This consideration may include fixed or variable amounts or both.

The transaction price is not adjusted for the effects of a customer's credit risk, but is adjusted if the company (eg based on its customary business practices) has created a valid expectation that it will enforce its rights for only a portion of the contract price (ie make a concession).

In the real estate and construction industries the transaction price can be impacted by a variety of facts and circumstances including, but not limited to:

- claims and incentive payments (variable consideration)
- materials or equipment provided to the company by the customer (non-cash consideration)
- time value of money.

Claims and incentive payments (variable consideration)

The amount of consideration received under a contract may vary due to items such as claims, performance bonuses, discounts, refunds, credits, price concessions, penalties and other similar items. Under existing IFRS, claims and incentive payments are included in contract revenue when it is probable the customer will accept the claim (or the related performance standards will be met), and the amount can be reliably measured.

Under IFRS 15, a company begins by estimating the amount of variable consideration using either the expected value (sum of probability weighted amounts) or most likely amount, whichever best predicts the amount of variable consideration to which the company will be entitled. An expected value approach might be appropriate in situations where a company has a large number of possible outcomes within a single contract (for example, a multi-tiered bonus structure). The most likely amount might be appropriate in situations where a contract has only two possible outcomes (for example, a bonus for early delivery that would either be received in its entirety or not at all). A company must use the same method to estimate variable consideration throughout the life of a contract.

Having estimated the amount of variable consideration it expects to receive, a company must then consider whether this amount needs to be constrained. The objective of the constraint is to allow companies to include variable consideration in the transaction price only to the extent it is highly probable there will not be a significant reversal of revenue when the related uncertainty is resolved. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, the following:

- the amount of consideration is highly susceptible to factors outside the company's influence
- the uncertainty is not expected to be resolved for a long time
- the company's experience with similar contracts is limited
- the company has a practice of offering a broad range of price concessions
- there are a large number and wide range of possible consideration amounts in the contract.

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Example 5 – Incentive payments

On 1 January 20X7 a construction services company enters into a contract with a customer for the construction of an oil refinery. The promised consideration is CU300 million, but this amount will increase if the company is successful in completing construction ahead of the agreed-upon deadline of 31 December 20X9. Specifically, the company is entitled to receive an additional CU50,000 for each week that construction is completed ahead of schedule. This performance bonus is a form of variable consideration.

The company considers the terms of the bonus clause and determines that the variable consideration should be estimated using the expected value method as this will provide the best estimate of the amount of the bonus to which it will ultimately be entitled. The company then applies the guidance above to determine whether any portion of this amount must be constrained.

In 'cost-plus' contracts the seller is entitled to consideration in the amount of the total costs incurred plus an agreed-upon margin. As total costs are not generally known until a contract is complete, the consideration is considered to be variable and the guidance above applies.

Practical insight – Variable consideration

Under IFRS 15, sellers must estimate the amount of variable consideration (for example, performance-based management fees) using either an expected value or most likely amount approach. This estimate is subject to a constraint permitting variable amounts to be included in the transaction price only when it is highly probable that a significant reversal of cumulative revenue will not occur when the uncertainty is resolved. This differs from existing guidance which focuses on whether it is probable that related performance requirements have been met and the amount can be measured reliably. As 'highly probable' is a higher threshold than 'probable' we expect this could lead to revenue recognition being delayed in some situations. Ultimately, judgement will be required to assess variable consideration under the new model, and the significance of the impact is likely to vary from entity to entity according to the nature of their contractual arrangements and the judgements made under existing standards.

In the real estate and construction industries the transaction price can be impacted by a variety of facts and circumstances.

Non-cash consideration

Under IFRS 15, when a customer promises consideration in a form other than cash (eg its own equity shares), the fair value of the non-cash consideration must be included in the transaction price. If the company is unable to reasonably estimate the fair value of the non-cash items, it measures the consideration indirectly by referring to the stand-alone selling price of the goods or services promised under the contract.

When a customer transfers control of goods or services (eg materials, equipment, labour) to facilitate a company's fulfilment of a contract, the goods or services contributed by the customer are treated as non-cash consideration.

While existing IFRSs do not provide specific guidance on how to account for non-cash consideration, the general guidance on non-monetary exchanges makes reference to the fair value of the goods received. As a result, it is likely that most entities will not see any significant changes in this area.

Time value of money

In the real estate and construction industries, payment terms may vary depending on the nature of the agreement, the financial resources of the customer and many other factors. Where a contract includes a significant financing component, it must be accounted for separately from revenue, and reported as interest revenue or expense in the statement of comprehensive income. This is true regardless of whether it is the seller or the customer that receives the financing.

IFRS 15 provides a number of indicators to help a company determine whether a significant financing component is present in a contract, including (among other things) the relationship between the promised consideration and the cash selling price, and the combined effect of the length of time between the transfer of the promised goods or services and when the customer pays and prevailing market rates of interest. As a practical expedient, the effects of financing may be ignored when the length of time between performance and collection is one year or less.

A contract may not have a significant financing component if:

- advance payments have been made but the transfer of the good or service is at the customer's discretion
- the consideration is variable based on factors outside the vendor's and customer's control (eg a sales-based royalty)
- a difference between the promised consideration and the cash price relates to something other than financing such as protecting one of the parties from non-performance by the other (see Example 6 below).

To adjust the amount of consideration for the time value of money, a company applies the discount rate that would be used in a separate financing transaction between itself and its customer at contract inception. That rate must reflect the credit risk of whichever party is receiving a benefit of financing (ie the customer if payment is deferred and the vendor if payment is in advance) and any collateral provided.

Example 6 – Significant financing components and customer holdbacks

A construction services company enters into a contract for the construction of a bridge. Construction is expected to take place over two years. During the construction phase the customer is required to make regular milestone payments intended to match the company's expected progress towards completion. Under the terms of the contract a specified percentage of each payment is to be withheld by the customer. Amounts withheld will be paid to the company only once the bridge is complete.

The company concludes that the contract does not include a significant financing component. IFRS 15 provides an exception to the normal rule when the mismatch between performance and payment arises for a reason other than financing. In this case the withholding of a specified percentage of each milestone payment is intended to protect the customer from the possibility the company might fail to adequately complete its responsibilities under the contract.

Under existing IFRSs, the focus is on vendor financing (ie payments received post-delivery) and measuring the fair value of the consideration to be received. There is no specific requirement to account for the financing effect of payments received in advance of performance, and thus the accounting for such arrangements is mixed. Under IFRS 15 the objective is to recognise revenue at an amount equal to the price the customer would have paid had they paid in cash at the time of performance, and both vendor- and customer-financing are of equal importance. The effect of these changes could be significant and companies will need to review their customer contracts carefully to ensure the effects of financing are captured and reported appropriately.

Practical insight – Uncertainty in the transaction price

Under IASs 18 and 11, uncertainty in the transaction price is partly a recognition issue. If the revenue amount cannot be measured reliably then either no revenue is recognised, or revenue is limited to the costs incurred to date assuming their recovery is probable. If a reliable estimate is available then the uncertain consideration would typically be measured at fair value. Assessing reliability may involve considerable judgement.

IFRS 15 has more specific and detailed guidance and will change some current practices. That said, in highly uncertain situations (eg some success fee-type arrangements when the outcome of the relevant contingency is unpredictable) the practical effect is likely to be the same – ie revenue is recognised only when the uncertainty is resolved. In situations involving a number of similar transactions, providing the company with relevant, predictive experience, we believe that IFRS 15 could lead to earlier recognition in some cases.

To adjust the amount of consideration for the time value of money, a company applies the discount rate that would be used in a separate financing transaction between itself and its customer at contract inception.

Step 4: Allocating the transaction price to the performance obligations

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

Estimating the stand-alone selling price

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

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

Table 1 – Estimating the stand-alone selling price

Method	Description
Adjusted market assessment approach	Involves evaluating the market in which a company sells goods or services and estimating the price that customers in that market would pay. A company might also consider price information from its competitors and adjust that information for differences in product features, cost structure and expected margins.
Expected cost plus margin approach	A company forecasts its expected costs of providing the goods or services and adds an appropriate margin.
Residual approach	Begin with the total transaction price and subtract the sum of observable stand-alone selling prices for other goods and services promised under the contract. This method is permitted only if a company: • sells the same good or service to different customers (at or near the same time) for a broad range of amounts; or • has not yet established a price for the good or service and has not previously sold it on a stand-alone basis.

When allocating revenue among the various performance obligations in a contract, IAS 18 and IAS 11 provide very little guidance. Therefore, the extent to which a company will be impacted by the new guidance will depend upon the accounting policy adopted under existing IFRSs.

Example 7 – Relative stand-alone selling price method

A construction services company enters into a contract for the construction of a hospital and adjacent pharmacy for a total contract price of CU250 million. Assume for purposes of this example that the hospital and pharmacy are determined to be separate performance obligations. The company is required to allocate the total contract price between the hospital and pharmacy using the relative selling price method.

The company is able to observe or estimate stand-alone selling prices for the hospital and pharmacy at CU280 million and CU20 million respectively. The total contract price of CU250 million is allocated as follows:

	SSP	Relative SSP (%)	Relative SSP ($)
Hospital	CU280 million	93.3%[1]	CU233.3 million[2]
Pharmacy	CU20 million	6.7%	CU16.7 million
Total	**CU300 million**	**100%**	**CU250.0 million**

1 280/300 = 93.3%
2 93.3% x 250 million = 233.3 million

Allocating discounts and variable consideration

A discount is present in a contract whenever the sum of the stand-alone selling prices for the promised goods or services exceeds the total consideration to be paid. The relative selling price method allocates this discount proportionately to each of the identified performance obligations, as illustrated in Example 7. However, a discount must be allocated to one or more (but not all) of the performance obligations if specific criteria are met. Those criteria focus on whether a company has observable evidence of the obligations to which the entire discount belongs.

In a similar way, variable consideration may be attributable to either an entire contract or only a specific part. Variable consideration must be allocated entirely to one or more (but not all) performance obligations if and only if specific criteria are met.

Allocating changes in the transaction price

If the transaction price changes other than through a contract modification (for example, when a company updates its estimate of variable consideration), the change must be allocated among the performance obligations on the same basis as at contract inception. Amounts allocated to satisfied performance obligations will impact revenue in the period the change occurs.

Contract modifications are discussed beginning at page 24.

Example 8 – Allocating a change in transaction price

A construction services company enters into a contract for the construction of a hospital and adjacent pharmacy for a total contract price of CU250 million. Assume for purposes of this example that the hospital and pharmacy are determined to be separate performance obligations and that revenue is recognised over time.

The company is entitled to a bonus payment of CU10 million if the foundations for both buildings are completed by 1 December. At the time the contract is signed, the stand-alone selling prices for the hospital and pharmacy are estimated at CU280 million and CU20 million respectively.

At inception of the contract, the company determines that it is likely to succeed in earning the bonus payment. However, it is unable to conclude that it is highly probable that a significant reversal will not occur, as there is still a reasonable chance that it will fail to meet the deadline. The bonus is therefore constrained, and the transaction price of CU250 million is allocated among the performance obligations on a relative stand-alone selling price basis (see Example 7).

The foundations are completed on 20 November. As a result, the company is now entitled to receive the bonus payment of CU10 million, and the transaction price is re-estimated at CU260 million. The revised transaction price is reallocated between the two performance obligations on the same basis as at inception:

	SSP (at inception – do not update)	Relative SSP (%) (unchanged from Example 7)	Relative SSP (CU – bonus)	Relative SSP (CU – total)
Hospital	CU280 million	93.3%[1]	CU9.3 million	CU242.7 million[2]
Pharmacy	CU20 million	6.7%	CU0.7 million	CU17.3 million
Total	**CU300 million**	**100.0%**	**CU10.0 million**	**CU260.0 million**

[1] 280/300 = 93.3%
[2] 93.3% x 260 million = 242.7 million

To the extent that the bonus is allocated to performance obligations that have already been satisfied, revenue is increased by way of a cumulative catch-up adjustment in the same period in which the transaction price changes.

Step 5: Recognising revenue when or as performance obligations are satisfied

Under IFRS 15 revenue for a performance obligation is recognised when control of the related good or service is transferred to the customer.

A customer obtains control of an asset (good or service) when it can direct the use of and obtain substantially all the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset.

Control transfers over time if any of three following conditions are met:

- the customer receives and consumes the benefits as the company performs (eg most services)
- 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 its performance to date.

If none of these conditions are satisfied, the seller recognises revenue at a point in time. Note that for this purpose, services are also considered to be assets, even if only momentarily, when they are received and consumed by the purchaser.

The first of these criteria is most often (and most readily) satisfied when dealing with routine services like office cleaning, building maintenance or administrative support. But for certain leasing or development activities it may be less clear whether the benefit of those services is received and consumed at the time the services are performed.

The second of these criteria is helpful in situations where it is clear that the customer controls the asset as it is created or enhanced. For example, this might be the case for some (but not all) contracts calling for the construction of a building on customer-owned land. It can be more challenging to apply to other construction-type contracts where the buyer does not have an ongoing right to access the building site, and legal title and physical possession transfer only when the contract is complete. In these cases companies will need to look carefully at the specific rights identified in the contract to determine whether the buyer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset while it is still under construction. When making this assessment, a company considers a buyer's ability to:

- use the asset to produce goods or provide services (eg occupying the lower stories of a partially-completed office tower while work continues on the remaining floors above)
- use the asset to enhance the value of other assets
- use the asset to settle liabilities or reduce expenses
- sell or exchange the asset before construction is complete
- pledge the partially-completed asset to secure a loan, and
- hold the asset.

Making this assessment can be challenging, and in many cases it will be unclear whether an asset under construction is controlled by the customer and exactly when that control transfers. **For this reason, we expect that many construction companies will support revenue recognition over time with a detailed analysis of the third criterion.**

Services are also considered to be assets, even if only momentarily, when they are received and consumed by the purchaser.

The third criterion is comprised of two parts, both of which must be met in order to recognise revenue over time. When evaluating whether an asset (eg construction-in-progress) has no alternative use to the seller, a company considers any impediments, contractual or practical, that would prevent it from transferring the partially-completed asset to another purchaser. If the contract language provides the seller with the right to substitute another asset of similar characteristics and quality, this would suggest that control over the asset does not transfer over time as performance occurs. With respect to a company's right to receive payment for performance completed to date, the amount should approximate the selling price of any goods or services transferred to date, including a reasonable profit margin. When making this assessment, a company considers not only the applicable contractual terms, but also any legislation, legal precedent or customary business practices that could override those contractual terms.

Practical insight – '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 noted above indicating that control of the unit transfers over time. When assessing the third ('no alternative use') criterion, a company 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 #15'), 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, a company considers whether it is entitled to enforce payment in the event the customer terminates the contract for reasons other than the company's own failure to perform. To satisfy this criterion, the right to receive payment should go beyond the mere reimbursement of costs incurred and reflect a normal selling price for the goods or services transferred to date (ie including a reasonable profit margin). Note also that the existence of a payment schedule does not necessarily mean that a company is entitled to an amount that at least compensates it for work completed to date if such amounts are refundable or are expected to lag behind performance.

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 typical off-plan residential unit sales contracts are currently structured, we believe that the new guidance may require some companies 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.

Practical insight – Guarantees

In some real estate contracts, a seller guarantees the return of its customer's investment or a return on that investment for an extended period of time. If this leads to a conclusion that a seller has retained significant financial risk in a project, this is one possible indicator that control may not have passed to the buyer. Under these conditions a seller needs to pay particular attention to the description of control in IFRS 15 and consider carefully whether the buyer has obtained "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset". If control of the asset has not been transferred to the buyer, revenue would not be recognised.

Similarly, if a property seller guarantees a buyer's financing, this is an example of a transaction that is partly in scope of IFRS 15 and partly in scope of IFRS 9. The seller applies IFRS 9 to initially measure the value of the guarantee and IFRS 15 to determine when it recognises revenue from both the guarantee and from the sale of property. In both cases, revenue cannot be recognised until control of the related asset has been transferred to the buyer.

As existing IFRSs focus on identifying whether the seller has transferred the significant risks and rewards of ownership to the buyer (rather than the transfer of control) caution is warranted. Depending on the facts and circumstances some companies may experience a change in the timing of revenue recognition when IFRS 15 is adopted.

Measuring progress towards completion

For performance obligations satisfied over time, a company recognises revenue over time in proportion to its progress towards completion of that performance obligation. The method chosen to measure this progress should reflect the pattern in which the company transfers control of the goods or services to the customer. This measurement must be updated from time to time as circumstances change and accounted for as a change in estimate under IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

For measuring a company's progress towards completion IFRS 15 identifies two broad approaches:

- output methods (eg surveys of performance completed to date, time elapsed, units produced, etc)
- input methods (eg labour hours expended or costs incurred relative to the expected total amounts).

For companies involved in the construction of residential or commercial real estate, the cost-to-cost method (an input method) is widely used. When applying input methods like cost-to-cost, it is important to exclude items from the calculation of progress when they do not faithfully reflect a company's progress in satisfying the performance obligation. The cost of procured but as yet uninstalled materials, for example, may not be proportionate to the company's progress in satisfying the performance obligation. Other costs, such as unexpected amounts of wasted materials, do not contribute to a company's progress at all. For some uninstalled materials where control of the good transfers to the customer before related services are provided, it may be appropriate to adjust the input method to recognise revenue only to the extent of the cost of the good. This might be appropriate when, for example:

- the good is not distinct
- the customer obtains control of the good before receiving services related to the good
- the cost of the transferred good is significant relative to the total expected costs, and
- the good is procured from a third party (ie not manufactured by the seller).

Example 9 – Input method with uninstalled materials

In February 20X8, a real estate developer enters into a contract with a customer to construct a new five story residential complex for total consideration of CU10 million. The terms of the contract are such that the developer's performance creates or enhances an asset (ie work-in-progress) that the customer controls as performance occurs. The developer considers the guidance in IFRS 15 and concludes that the project represents a single performance obligation satisfied over time. Total expected costs are CU8 million, including CU1.6 million for state-of-the-art solar panels which, once installed, will supply up to 75% of the building's electrical needs. The developer obtains control of the solar panels from a third party supplier before transferring them to the building site (and in this case, the customer).

The developer uses the cost-to-cost method to measure its progress towards completion of the building. The customer obtains control of the solar panels when they are delivered to the site in November 20X8, although they will not be installed until May 20X9. The solar panels represent 20% of the total estimated costs of the project, and this cost is considered to be significant.

At 31 December the solar panels remain uninstalled and under the control of the customer. As the cost of the solar panels represents 20% of the total estimated costs of the project, but the panels required very little effort to procure, the developer concludes that it would be overstating its estimate of performance if it included the costs of the solar panels in its cost-to-cost calculations. As a result, the developer removes the cost of the solar panels from its cost-to-cost calculations, recognising revenue for the transfer of the solar panels in an amount equal to their cost (ie at a zero margin) (see IFRS 15.B19(b)).

As of 31 December 20X8 other costs incurred (excluding the solar panels) are CU3.2 million and performance is therefore considered to be 50% complete (ie CU3.2 million ÷ [CU8.0 million – CU1.6 million]). As a result, at 31 December the developer recognises the following:

	CU (millions)
Revenue (solar panels)	1.6
Revenue (rest of project @ 50%)	4.2[1]
Total revenue	5.8
Cost of goods sold	4.8[2]
Profit	**1.0**

[1] 50% × (CU10 million – CU1.6 million)

[2] CU1.6 million cost of solar panels plus CU3.2 milion in other costs incurred

Note that had the developer not adjusted its calculations as shown above, it would have recognised profit of CU1.2 million, an increase of 20%.

Ability to reasonably measure progress

A company recognises revenue for a performance obligation satisfied over time only if it can reasonably measure its progress towards completion of that performance obligation. A company is not able to reasonably measure its progress towards completion if it lacks reliable information that is required to apply an appropriate method of measurement.

In some cases, such as during the early stages of a contract, a company might not be able to reasonably measure its progress towards completion, but may still expect to recover its costs incurred in satisfying the performance obligation. In this situation, a company recognises revenue only to the extent of costs incurred until it can reasonably measure its progress.

Control transferred at a point in time

In situations where control over an asset (good or service) is transferred at a single point in time, a company recognises revenue by evaluating when the customer obtains control of the asset.

In performing this evaluation, a company considers various indicators of control including, but not limited to, the following:

- the company has a present right to receive payment for the asset
- the customer has legal title to the asset
- the customer has physical possession of the asset
- the customer has assumed the significant risks and rewards of owning the asset
- the customer has accepted the asset.

The transfer of legal title, for example, often indicates the transfer of control. However, where the seller retains legal title solely as a means of protecting itself against a customer's failure to pay, that retention of title does not preclude the possibility that the customer has obtained control of the asset.

A company recognises revenue for a performance obligation satisfied over time only if it can reasonably measure its progress towards completion of that performance obligation.

Other important considerations

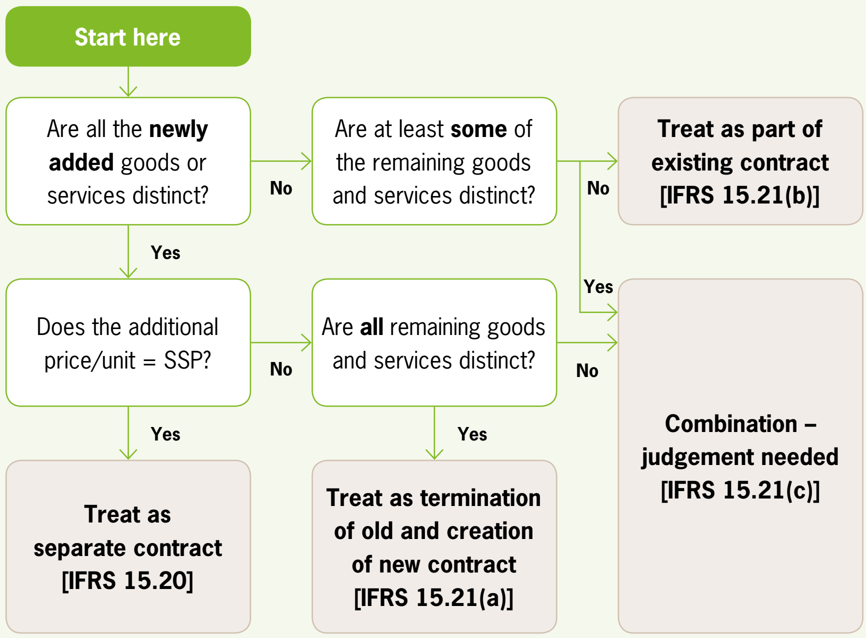
Contract modifications

In construction and real estate contracts it is common for the scope or pricing of a contract to change in response to a variety of circumstances not foreseen at inception (often referred to as 'change orders' or 'variations'). While frequently documented in writing, these modifications can also be effected by oral agreement or even implied by customary business practices. When deciding how to account for a modified contract, a company must first determine whether the modification is considered to be a separate contract. A company accounts for a modification as a separate contract, if both:

- the scope changes due to the addition of 'distinct' goods or services (see Step 2)
- the price change reflects the stand-alone selling prices of the newly added goods or services.

When a modification is treated as a separate contract, only future revenue is impacted as the company will continue to account for the pre-modification elements of the contract as before.

Diagram 3 – Treatment of contract modifications



When a modification does not satisfy the conditions needed to support treatment as a separate contract, the accounting will depend on whether the remaining goods and services under the modified contract are 'distinct' from those already transferred to the customer at the modification date:

- If all remaining goods or services are distinct from those already transferred to the customer at the modification date (including those newly added under the terms of the modification), then the modification is treated as a termination of the original contract and the creation of a new contract. The transaction price to be allocated to the remaining performance obligations is the total consideration promised by the customer (as modified) less the amount already recognised as revenue. No adjustments are made to the amount of revenue recognised on or before the modification date. If a change to an amount of variable consideration arises subsequently but relates to performance occurring before the modification date, then the guidance on variable consideration applies.
- If none of the remaining goods or services are distinct from those already transferred to the customer at the modification date, but they form part of a single performance obligation that is partially satisfied as of the modification date, a company adjusts both the transaction price and the measure of progress towards completion for that performance obligation. Revenue recognised to date is adjusted for the contract modification on a 'cumulative catch-up' basis. This treatment usually results when, for example, a construction company agrees with its customer to upgrade an in-progress building's agreed-upon specifications for an additional charge.
- If the remaining goods or services are a combination of these scenarios a company accounts for the effects of the modification on unsatisfied or partially satisfied obligations consistently with the guidance above. No adjustments are made to the amount of revenue recognised for separate performance obligations satisfied on or before the modification date.

Example 10 – Basic modification

A property management company enters into a two-year agreement to manage a rental property. The owners of the rental property commit to pay CU50,000 per year. The property management company routinely sells these service to other parties on a stand-alone basis at the same rate. At the end of the first year, the management company agrees to reduce the fee for the remaining year to CU40,000 (the stand-alone selling price of the services at that time). At the same time, the customer agrees to extend the contract for an additional two years for total consideration of CU70,000 payable at the beginning of years three and four in two equal instalments of CU35,000. Immediately following the modification, the contract has three years remaining, and entitles the company to consideration of CU110,000.

The company determines that it is not able to account for the modification as a separate contract. Although the additional services are considered to be distinct from those originally promised, the price of the contract has not increased by an amount that reflects the company's stand-alone selling price of the additional services, measured on the date of the modification. The company will therefore account for the modification as a termination of the original contract and creation of a new contract. As the total remaining consideration is CU110,000 (CU40,000 + CU70,000), the company recognises revenue of CU36,667 per year over each of the three remaining years in the contract.

If the parties to a contract approve a change in scope before agreeing on the corresponding change in price, the seller uses an estimate of the change in transaction price when applying the modification guidance above. The constraint on variable consideration also applies – see Step 3.

Example 11 – Change in price not yet agreed

A construction company has agreed to upgrade the flooring spec on all levels of a building currently under construction. While the final details of the flooring have been agreed, the company is still in the process of coming to an agreement with its customer on the additional compensation to be paid as a result of this change. The contract was previously determined to consist of a single performance obligation (ie the building) with revenue being recognised over time.

In this case the construction company estimates the change in the transaction price arising from the modification and applies the constraint. As the upgraded flooring and all remaining goods or services to be transferred under the original contract are not considered to be 'distinct' from the goods or services already transferred to the customer, the company updates its measure of progress towards completion for the building and applies this to the revised transaction price. Revenue recognised to date is updated on a 'cumulative catch-up' basis.

Incremental costs of obtaining a contract

IFRS 15 requires a company 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 a company would not have incurred had it not obtained the contract (some sales commissions, for example).

In order to obtain work, most companies in the real estate and construction industries find they must participate in a competitive tendering process. Developing a tender, or bid, involves a variety of costs as the prospective builder works to gain an understanding of a project's requirements, develop its materials requirements list, and obtain cost estimates from potential trade subcontractors. Costs that a company incurs regardless of whether it obtains a contract (eg most bid costs) are expensed as incurred, unless the costs are explicitly chargeable to the customer whether or not the company obtains the contract. When a company is required to undertake design or other project planning activities as part of the tendering process, these are considered for capitalisation as fulfilment costs using the criteria described in the next section.

As a practical expedient, IFRS 15 allows a company to expense the incremental costs of obtaining a contract as incurred if the amortisation period of the asset that the company would have otherwise recognised is one year or less.

Costs to fulfil a contract

If costs incurred in fulfilling a contract with a customer are covered under another Standard (such as IAS 2 'Inventory' or IAS 16 'Property, Plant, and Equipment'), a company accounts for those costs in accordance with that Standard. Otherwise, a company recognises an asset for those costs, provided all of the criteria in the table below are met. With the exception of mobilisation and other similar up-front costs, we expect that many companies in the real estate and construction industries will be expensing fulfilment costs as they are incurred, while recognising revenue over time.

Table 2 – Contract fulfilment costs

Costs are capitalised if all of the following conditions are met:

- the costs relate directly to a contract (or anticipated contract), including:
  - direct labour
  - direct materials
  - allocations that relate directly to the contract or contract activities (for example, contract management and supervision costs and depreciation of tools and equipment used in fulfilling the contract)
  - costs that are explicitly chargeable to the customer
  - other costs that the entity incurs only because it entered into the contract (eg payments to subcontractors)
- the costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future
- the entity expects to recover the costs.

Costs to be expensed as incurred include:

- general and administrative costs that are not explicitly chargeable to the customer
- costs of wasted materials, labour or other resources that were not reflected in the contract price
- costs that relate to satisfied performance obligations
- costs related to remaining performance obligations that cannot be distinguished from costs related to satisfied performance obligations.

Practical insight – Mobilisation costs

A construction services company typically incurs a variety of costs while preparing to perform under a contract (ie 'mobilisation costs'). These costs will include such things as planning the layout of the construction site, obtaining statutory drawings of all the existing utilities in the vicinity of the site, and selecting suppliers to provide on-site catering and security. The new guidance will require businesses to re-examine how they account for these costs.

While IAS 11 allows mobilisation costs to be capitalised and amortised over the life of the contract, many construction businesses tend to expense these costs as incurred. IFRS 15 will require such costs to be capitalised where the specific criteria in IFRS 15 are met. The impact on each company will therefore depend entirely on the specifics of each customer contract and the policies historically applied under existing IFRSs.

Amortisation and impairment of contract costs

Under IFRS 15, a company amortises capitalised contract costs on a systematic basis consistent with the pattern in which the related goods or services are transferred to the customer. If a company identifies a significant change to the expected pattern of transfer, it updates its amortisation to reflect the change in estimate in accordance with IAS 8.

A company recognises an impairment loss in earnings if the carrying amount of an asset exceeds the remaining amount of consideration the company expects to receive in connection with the related goods or services less any costs directly related to providing those goods or services that have not yet been recognised as expenses. When determining the amount of consideration it expects to receive, a company ignores the constraint on variable consideration previously discussed, and adjusts for the effects of the customer's credit risk.

Sale-leaseback transactions

The accounting for sale and leaseback transactions falls under IAS 17 'Leases' (or IFRS 16 'Leases') and may result in the deferral of a portion of the revenue that might otherwise be recognised by the seller-lessee. The new leasing guidance confirms that the assessment of whether or not a sale has occurred is made using the guidance in IFRS 15.

A sale-leaseback transaction with a customer put option that obligates the seller-lessee to repurchase the asset at the customer's request would call into question whether control of the asset had been transferred to the customer and thus whether a sale had actually occurred. If a sale has not occurred, then the arrangement is treated as a financing. In this situation the seller-lessee continues to recognise the transferred asset and recognises a financial liability equal to the transfer proceeds. This financial liability (and the corresponding financial asset recognised by the buyer-lessor) are accounted for under IFRS 9 'Financial Instruments'.

IFRS 15 provides detailed guidance on how to account for sales subject to repurchase agreements (calls, forwards and puts) and a careful analysis of the facts and circumstances surrounding each arrangement is required.

Onerous contracts

IFRS 15 does not include any guidance on how to account for contracts in which the unavoidable costs of performing under the contract exceed the economic benefits expected to be received from it. Accordingly, such contracts will be accounted for using the guidance in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

Under IAS 37, the assessment of whether a provision needs to be recognised takes place at the contract level. Under IAS 11, when a contract calls for the construction of two or more assets, the construction of each asset is treated as a separate contract if certain criteria are met (ie segmentation). This means that each segment is assessed separately to determine whether it is onerous. If the construction of one asset is onerous and expected to generate a loss, for example, a provision is booked even if the second asset and contract as a whole are not onerous. This may change once a company has adopted IFRS 15. Similar segmentation provisions have not been included in the new Standard, and IAS 37's 'contract' appears to be a higher unit of account than IFRS 15's 'performance obligation'. Once a company has adopted IFRS 15, then, the assessment of whether a contract is onerous will be performed at the contract level and not the performance obligation level. In addition, when IFRS 15 requires an entity to combine two or more contracts entered into at or near the same time, the assessment of whether the contract is onerous should be performed at the level of the combined contracts (ie the 'contract' from the point of view of IFRS 15).

Practical insight – Assessing whether a contract is onerous

When assessing whether a contract is onerous, IAS 37 requires companies to consider the economic benefits expected to be received but does not define in detail exactly what that means. Under existing IFRSs the analysis would either include revenues that are more likely than not to be received, or be performed on a probability weighted basis. We believe this approach will continue to apply in the future and that companies will not be required to apply the IFRS 15 constraint when estimating the economic benefits to be received. Assessing whether a contract is onerous is guided by IAS 37, while the constraint is a feature of IFRS 15.

One further impact can be expected due to the fact that a loss contract under IAS 11 is measured using an estimate of the total contract costs (including, for example, an appropriate allocation of construction overheads). This is likely to be greater than the 'unavoidable costs' identified under IAS 37.

Warranties

A company acting as a primary contractor may provide its customers with a warranty over construction. While the involvement of subcontractors in a construction project adds some legal complexity for the parties involved, from an accounting perspective the basic principles are the same as in other industries. When a warranty provides the purchaser with assurance that a new building has been constructed in accordance with agreed-upon specifications and is free from latent defects it is generally accounted for using the cost accrual guidance in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'. When a customer can purchase a warranty separately, or all or part of a warranty provides a customer with an additional service beyond the basic assurance described above, it is treated as a separate performance obligation. In this case the developer allocates a portion of the transaction price to that service unless it cannot reasonably account for the assurance and service portions of the warranty separately. If it cannot reasonably separate the assurance and service components of a warranty, it accounts for both together as a single performance obligation.

Presentation

Under IFRS 15 a company presents a contract in its statement of financial position as either a contract liability or a contract asset depending on the relationship between the company's performance and the customer's payments as at the reporting date. A company's unconditional right to consideration is presented separately as a receivable. Diagram 4 summarises the circumstances under which various assets and liabilities arise.

A company presents a contract as a liability whenever the consideration received (or due) from the customer exceeds the revenue recognised for performance to date (entries 1, 5, and 6 in the Diagram). Conversely, if the company has transferred goods or services as of the reporting date which the customer has not yet paid for, the company recognises either a contract asset or a receivable (entries 2, 3 and 4). A company recognises a receivable to the extent that only the passage of time is required before payment of the amount is due (or the amount is already due); otherwise, a company recognises a contract asset.

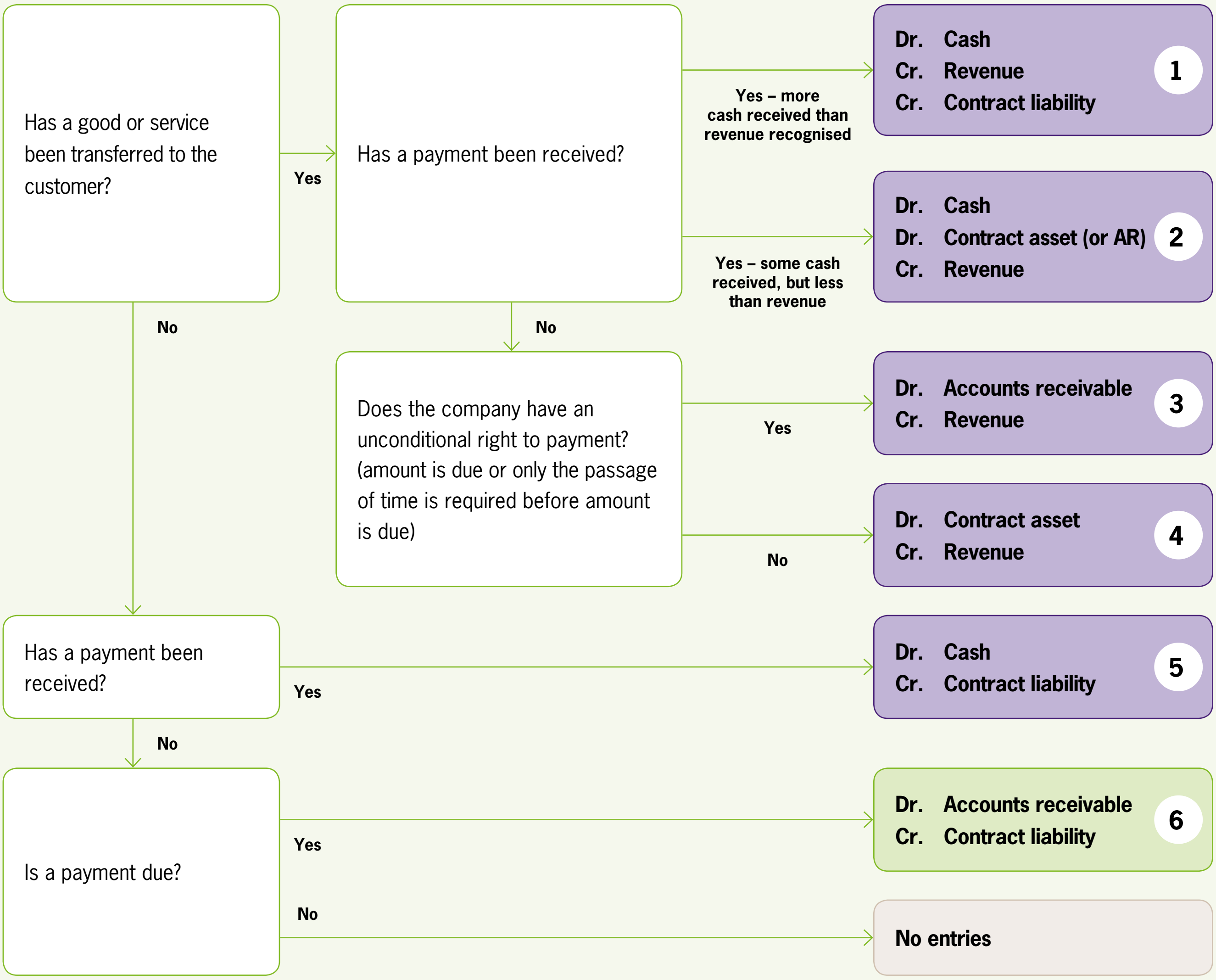
Practical insight – Presentation of contract assets and liabilities

IFRS 15 does not require the use of specific labels when presenting contract assets or liabilities on the statement of financial position. If, for example, a company previously concluded it is appropriate to describe its contract liabilities under the caption 'deferred revenue', it may continue to do so.

Similarly, many construction-type contracts include detailed billing schedules itemising the amounts that will be paid by the purchaser on specific dates or upon achievement of various milestones. When a contract asset or receivable results because the revenue recognised to date exceeds the amount of consideration received from a customer (commonly encountered when construction holdbacks are present), a company will have some flexibility in selecting the appropriate captions. If, for example, a company previously concluded it is appropriate to use the caption 'Unbilled accounts receivable' in its financial statements to describe certain assets, it may continue to do so. Although in this case care must be taken to ensure it is clear to a reader whether this is a subcategory of receivables (ie only the passage of time is required before the amount is due) or a contract asset.

Under previous IFRSs journal entry 6 in Diagram 4 was discouraged based largely on a definition of deferred revenue that focused on the receipt of cash in advance of revenue being recognised. Under IFRS 15 companies will be required to recognise this entry whenever an amount is due under a contract (but not yet received) and performance has not yet occurred. This will represent a change in practice for many.

Diagram 4 – Receivables, contract assets and contract liabilities under IFRS 15



Under IFRS 15 a company presents a contract in its statement of financial position as either a contract liability or a contract asset depending on the relationship between the company's performance and the customer's payments as at the reporting date.

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 needed to comply with the new Standard. Some of the more significant new disclosures include:

Table 3 – Summary of disclosure requirements	
General	• revenue recognised from contracts with customers, separately from other sources of revenue • impairment losses on receivables and contract assets
Disaggregation of revenue	• categories that depict the nature, amount, timing, and uncertainty of revenue and cash flows • sufficient information to enable users of financial statements to understand the relationship with revenue information disclosed for reportable segments under IFRS 8 'Operating Segments'
Information about contract balances	• including opening and closing balances of contract assets, contract liabilities, and receivables (if not separately presented) • revenue recognised in the period that was included in contract liabilities at the beginning of the period and revenue from performance obligations (wholly or partly) satisfied in prior periods • explanation of relationship between timing of satisfying performance obligations and payment • explanation of significant changes in the balances of contract assets and liabilities
Information about performance obligations	• when the entity typically satisfies performance obligations • significant payment terms • nature of goods and services • obligations for returns, refunds and similar matters • types of warranties and related obligations • aggregate amount of transaction price allocated to remaining performance obligations at end of period[1]
Information about significant judgements	• judgements impacting the expected timing of satisfying performance obligations • methods used to recognise revenue for performance satisfied over time, with explanation • the transaction price and amounts allocated to performance obligations (eg estimating variable consideration and assessing if constrained and allocating to performance obligations)
Assets recognised from the costs to obtain or fulfil a contract	• judgements made in determining costs capitalised • amortisation method used • closing balances by main category and amortisation expense

[1] not required if (i) the performance obligation is part of a contract which has an original expected duration of less than one year; or (ii) the entity applies an expedient to recognise revenue at the amount it is entitled to invoice when this corresponds directly with the value the customer obtains from the entity's performance

Other business impacts

In addition to the accounting impacts discussed above, the introduction of this important new Standard has the potential to impact other areas of a business in a significant way, including the following.

Investor relations

Consider whether owners and other stakeholders have been provided with all the information they need in order to understand the impacts that the new Standard will have on the company and its financial information.

Bank covenants

With changes to the guidance on recognising revenue over time versus at a point in time and on the capitalisation of costs to acquire or fulfil a contract, recognised assets and liabilities may be changing and this could impact compliance with existing loan covenants. Identify any potential risks and begin discussions with lenders well in advance.

Bonus and other compensation plans

Where significant impacts on the timing of revenue recognition have been identified, consider whether changes need to be made to the Company's bonus and other compensation plans in order to ensure that payouts remain aligned with the Company's compensation objectives.

Accounting systems and related processes

IFRS 15 will require companies to capture and track new information, especially when it comes to complying with the enhanced disclosure requirements. Consider whether existing systems can be adapted or must be replaced, and begin the assessments and vendor searches early.

Staff training

Identify any supplemental training staff will need in order to understand the new requirements and work effectively with new or modified accounting systems and processes.

Internal budgeting

Consider that changes to the way in which revenue is recognised can impact the timing of related corporate tax instalments and other cash flow items like employee compensation plans. There are also likely to be a variety of one-time costs associated with transition, such as the cost of hiring additional staff to analyse the impact on existing contracts-in-progress, and the cost of making changes to legacy software systems.

3. Effective date and transition

IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2018. Early adoption is permitted.

Entities are required to apply the new revenue standard either:

- retrospectively to each prior period presented, subject to some practical expedients or
- retrospectively, with the cumulative effect of initial application recognised in the current period.

A company that chooses to restate only the current period is required to provide the following additional disclosures in the initial year of adoption:

- for each financial statement line item, the current year impact of applying the new revenue standard
- an explanation of the reasons behind the significant impacts.

Contacts

Global Leader, Real Estate and Construction
Sian Sinclair
Australia
T +61 7 3222 0330
E sian.sinclair@au.gt.com

Asia Pacific
Sian Sinclair
Australia
T +61 7 3222 0330
E sian.sinclair@au.gt.com

Wilfred Chiu
China
T +86 10 8566 5828
E wilfred.chiu@cn.gt.com

Europe and Middle East
Kersten Muller
UK
T +44 (0)20 7728 3139
E kersten.j.muller@uk.gt.com

Americas
Alvin Wade
United States
T +1 214 561 2340
E alvin.wade@us.gt.com

Bo Mocherniak
Canada
T +1 416 360 3050
E bo.mocherniak@ca.gt.com

Africa
Lee-Anne Bac
South Africa
T +27 105 907 246
E lee-anne.bac@za.gt.com

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