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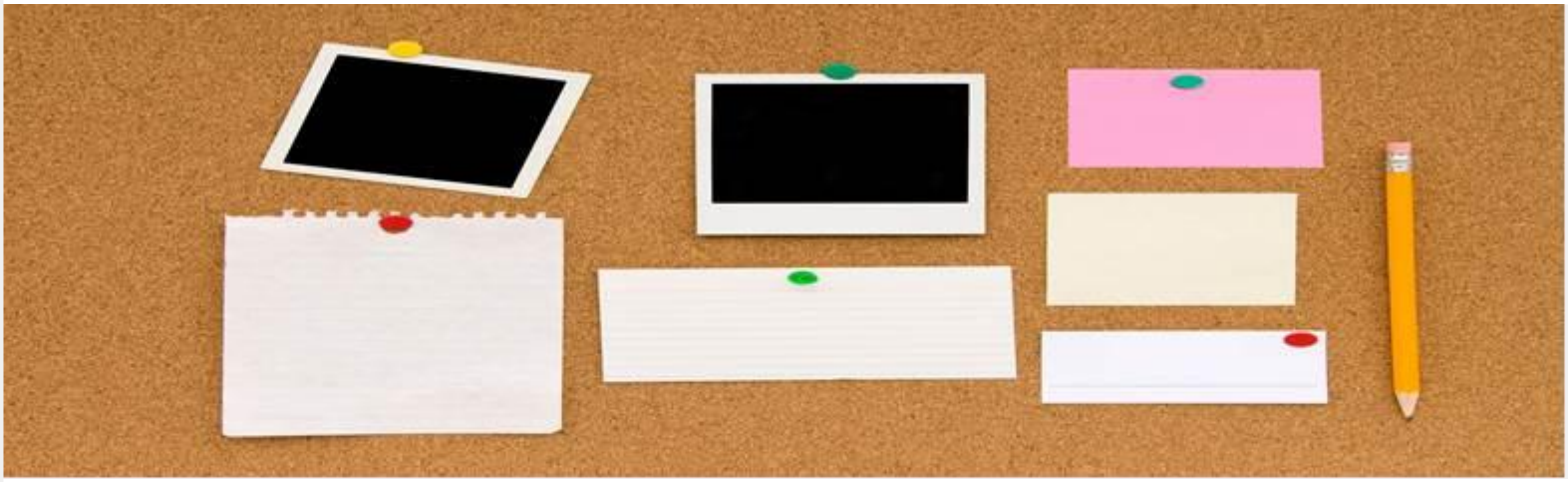

Accounting & Auditing News

IFRS 15 — *Revenue from Contracts with Customers*: Part 3H – Impact on Real Estate Sector

PROPERTY DEVELOPERS AND CONSTRUCTION COMPANIES

<u>How are different goods and services within a contract identified?</u>

Background

Given the lack of specific guidance in IFRSs, there was greater room for judgment when identifying the distinct goods and services within a contract. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15, and in particular, the new rules on how revenue is allocated between different items.

Effect

Construction companies often have multi-element contracts and IFRS 15 may have the determination of whether certain elements of a contract are recognized separately, which may have significant impact on the profile on revenue recognition. It may also, affect the identification of separate service obligations (and the timing of recognition of the related revenue) included in the construction contract covering the design, construction and operation phases of a real estate project.

Should contract costs be capitalized?

Background

The new standard introduces specific criteria for determining whether to capitalized certain costs, distinguishing between those costs associated with obtaining a contract (e.g. sales commissions) and those costs associated with fulfilling a contract.

Effect

This becomes an issue for construction companies where significant costs are incurred that are directly attributable to obtaining contracts with customers, for example bid costs incurred prior to a contract being awarded. This may include costs related to fulfilling a contract or costs of obtaining a contract and accounting treatment will be dependent on the nature (type) of costs incurred. Success fees will be capitalized under the new standard as they are incremental costs of obtaining a contract. At present, different entities might treat various types of cost differently so there may be an impact on operating profits.

The new standard requires capitalized contract costs to be amortized on a systematic basis that is consistent with the pattern of transfer of the goods or services. Entities will need to exercise judgment to determine the appropriate basis and time period for this amortization.

Should Revenue be Recognized Over Time or at a Point in Time?

Background

IFRS 15 introduces a new approach to determine whether revenue should be recognized over time or at a point in time. Three scenarios are specified in IFRS 15 in which revenue will be recognized over time. If revenue is to be recognized over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. If a transaction does not fit into any of the three scenarios specified in IFRS 15, revenue will instead be recognized at a point in time, when control passes to the customer.

Effect

Recognizing revenue over time or at a point in time will often depend on careful analysis of specific contract terms. Quite small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition. In determining whether revenue on such is recognized at a point in time or over time, particular care will need to be given to whether the entity could have an alternative use for the asset under construction and the entitlement of the entity to be paid for the work performed to date. It will often be particularly important to focus on contractual terms that allow the customer to cancel, curtail or significantly modify a contract and whether, in such cases, the seller is entitled to adequate compensation for work performed to date.

<u>Should revenue be adjusted for the effects of the time value of money?</u>

Background

IFRS 15 introduces new and more extensive guidance on financing arrangements and the impact of the time value of money. Sale by property developers or construction companies may include financing arrangements in that the timing of cash inflows from the customer may not correspond with the timing of recognition of revenue.

Effect

Under the new standard, the financing component, if it is significant, is accounted for separately from revenue. This applies to payments in advance as well as in arrears, but subject to an exemption where the period between payment and transfer of goods or services will be less than one year. This new guidance may change current accounting practices in some cases.

<u>What is the impact if a contract is modified?</u>

Background

In the past, IFRSs included only limited guidance on how to account for modifications to a contract. IFRS 15 includes detailed guidance on whether a contract modification should be accounted for prospectively or retrospectively.

Effect

It is not uncommon for the scope of price arrangements in the real estate sector to be modified, particularly for construction companies and therefore this requirements may result in a change of practice for some entities.

PROPERTY MANAGERS

When should variable or uncertain revenues be recognized?

Background

Property management contracts often include significant variable elements, such as performance bonuses, rental guarantees, profit sharing arrangements relating to the subsequent sale of real estate, etc. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognized would not be subject to significant future reversals as a result of subsequent re-estimation.

Effect

This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgment to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result.

The Philippine Interpretations Committee (PIC) is currently studying the impact of the new standards on Real Estate Sector.

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