

MFRS in Focus

IFRIC 15: The final verdict?

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The current status of IFRIC 15

As we all know, IFRIC 15, IC Interpretation No.15 (the equivalent of Malaysia) was supposed to take effect on July 2010, the Malaysian Accounting Standards Board (MASB) decided to defer the implementation date to 2012 in view of the new standard on revenue recognition to be issued by the International Accounting Standards Board (IASB) scheduled to be released in 2012.

Report on IFRIC 15 after Interpretation Committee meeting on 3 – 4 November 2011

(Source: Deloitte IAS Plus: IFRS Interpretation Committee Past Meetings – November 2011 Meeting)

IFRIC 15 Agreement for the Construction of Real Estate – Clarification of continuous transfer

The Committee had previously received an inquiry related to IFRIC 15 and recognition of revenue under continuous transfer. Specifically, the submitter asked for clarification on (1) does continuous transfer of control mean that the buyer receives control over the part-completed work of progress or the seller loses control and the buyer gains protective rights, (2) does control mean that the buyer has legal or physical possession of the work in progress while construction takes place; or is it sufficient that the seller is unable to sell the work in progress to anyone else, and (3) whether the unit of account is each individual unit or the entire block.

Interrelated with this interpretation of IFRIC 15 is the Board's pending project on revenue recognition which is developing guidance on the meaning of transfer and continuous transfer. During a meeting earlier in 2011, the Committee recommended that the Board should consider the fact pattern received by the Committee in its revenue project. However, before concluding on this issue, the Committee asked for further input on this issue from interested parties.

The staff (i.e. the IFRS Foundation) presented the Committee with transactions from two separate jurisdictions with an analysis of whether each transaction met the continuous transfer requirements in IFRIC 15.

1. Jurisdiction A

In jurisdiction A, property developers are highly regulated and licensed by a local Housing Act. Once the sales contract has been executed, the buyer has no right to rescind the contract unless the developer totally fails to perform in respect of any matters arising out of the agreement or the buyer cannot obtain financing. The buyer is also required to make non-refundable payments throughout the construction process based on certified stages of progress with 80% of the price paid to the developer before completion of the development. Jurisdiction A also requires specific performance by both parties to the contract.

2. Jurisdiction B

In jurisdiction B, developers are subject to building standards but otherwise not regulated as they are in jurisdiction A. Buyers in this jurisdiction are less tied into a sales contract with typically only a 10% deposit required at contract execution and the remainder due upon completion of the property. The buyer may choose not to perform under the contract but would forfeit the deposit and may be legally liable for any differences between the ultimate sales price and the original sales price. Contract terms also typically allow the developer to terminate the contract without penalty. Specific performance may be required by the courts but is not required by legal statute.

Staff's Analysis

The staff's analysis focused on the risk and rewards that each party was subject to and consideration of the transfer of control. Based on their analysis of numerous factors, the staff believed that the transfer to the buyer is continuous in jurisdiction A while it occurs at a point in time in Jurisdiction B.

The staff also presented the Committee with an analysis of the unit of account for consideration of continuous transfer. The analysis focused on whether the unit of account represented the individual unit or the entire block.

The staff concluded that the appropriate unit of account for assessment of continuous transfer is the individual unit.

What is next?

The Committee members had various views but several expressed certain issues with the staff analysis. Ultimately, because of the correlation between the interpretation of IFRIC 15 and the revenue recognition proposals, the Committee will seek the Board's advice on how to further address the issue.

Revised Exposure Draft (ED) on Revenue Recognition – in a nutshell

(Source: Deloitte IFRS in Focus – IASB issues revised exposure draft on revenue recognition – November 2011)

Following feedback on the original exposure draft issued in June 2010 and further deliberations, the IASB issued a revised ED on Revenue Recognition in November 2011. The new ED is the next step in developing an entirely new revenue recognition standard.

The underlying approach in the revised ED is broadly consistent with that of the original ED which is driven primarily by a model of recognising revenue as an entity delivers goods and services to a customer. However, the revised ED contains more detailed guidance than existing IFRSs and many changes have been made regarding the application of the model.

As a result of these changes, and given the importance of the revenue line item to users of financial statements, the Boards [the IASB and the Financial Accounting Standards Board (FASB)] decided to expose for public comment a revised ED.

The Boards are seeking comments from constituents on whether the proposals are clear and can be applied in a way that effectively communicates to users of financial statements the economic substance of an entity's contracts with customers.

The Boards invite comments on six specific areas in the revised ED on which constituents previously have not had the opportunity to comment:

1. Determining when a performance obligation relating to the transfer of a good or service is satisfied over time;
2. Presenting the effects of a customer's credit risk as a separate line item adjacent to the revenue line item;
3. Constraining the cumulative amount of revenue recognised to date to amounts to which entity is reasonably assured to be entitled;
4. Applying the onerous test to a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year;
5. Requiring revenue disclosures in interim financial reports; and
6. Determining when to derecognise transferred non-financial assets that are not an output of an entity's ordinary activities.

Core principle of the revised exposure draft

The revised ED's core principle is that **an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services.**

The proposals list five steps for entities to follow in the recognition of revenue for contracts within the revised ED's scope:

- Step 1 : Identify the contract with customer;
- Step 2 : Identify the separate performance obligations in the contract;
- Step 3 : Determine the transaction price;
- Step 4 : Allocate the transaction price to the separate performance obligations in the contract; and
- Step 5 : Recognise revenue when (or as) the entity satisfies each performance obligation.

These steps are consistent with those identified in the original ED; however, various changes have been proposed to their implementation. Please refer to the revised ED for further details. Click [here](#) for the revised ED.

One significant change from the original Exposure Draft

The original ED introduced the concept of “control” in the determination of when a good or service transfers to a customer and thus, when revenue is recognised, which may be at a point in time or over a period.

The Boards decided to modify the proposed indicators of when a customer obtains control at a point in time and to provide additional guidance that an entity must consider in determining whether control transfers continuously over time (including clarifying how an entity should measure its progress towards completion of a performance obligation that is continuously satisfied).

Transfer of control over a period

An entity satisfies a performance obligation continuously if at least one of the following two criteria is met:

1. The entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g. customer controls the work in progress (WIP)).
2. The entity’s performance does not create an asset with alternative use to the entity (e.g. the contract does not allow the entity to sell the WIP to another customer or the WIP is highly customised and would not be suitable for another customer) and at least one of the following criteria is met:
 - (a) The customer simultaneously receives and consumes the benefit as the entity performs each task;
 - (b) Another entity would not need to substantially re-perform the work completed to date if that other entity were to fulfill the remaining obligation to the customer (without having access to WIP or any other asset controlled by the entity); or
 - (c) The entity has a right to payment (assuming that the seller complies fully with its contractual obligations) for performance completed to date and expects to fulfill the contract as promised. If the customer cannot cancel the contract, or the full contract price is payable on cancellation, this would appear to meet the criteria. If the contract can be cancelled by the customer and a fixed amount is payable on cancellation, which is lower than the total contract price, this may not be considered to compensate for performance to date and therefore may not satisfy this criterion.

Deloitte’s observation

There is a subtle but significant shift in focus of construction-type activity. The existing guidance in IAS 11 and IFRIC 15 focuses on whether an item is constructed to a customer-specific design. The revised ED instead focuses on whether the asset under construction has “alternative use” to the entity. This may result in a different analysis in some cases, particularly for some property contracts.

Transition

An entity would be required to apply the proposed revenue standard retrospectively, subject to the following optional reliefs:

- not restating for contract that begin and end within the same annual reporting period and were completed before the date of initial application;
- using the final transaction price for contracts with variable consideration which were completed before the date of initial application;
- not requiring the onerous test to be performed before the date of initial application unless an onerous contract liability was recognised previously; and
- not requiring disclosure for prior periods of the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue.

Requirement

1. If an entity applies the standard retrospectively subject to any of the above reliefs, it would be required to state which reliefs have been taken and provide a qualitative assessment of the likely effect of applying those reliefs.
2. An entity would apply any expedients consistently to all reporting periods presented. In addition, an entity would disclose the expedients that have been used and, to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

Deloitte's observation

The revised ED's provision of some relief from full retrospective application of the new standard will alleviate some concerns about the cost and effort to apply the proposals retrospectively. However, even with the availability of the reliefs, the adoption of the final standard may require a significant amount of cost and effort for the following reasons:

1. Entities may need to review their internal information systems to determine if there is a need to modify their internal systems, controls and processes to gather necessary information to comply with the new disclosure requirements and changes in revenue recognition and cost capitalisation in a consistent manner.
2. Entities may need to assess the implications of any potential changes to the presentation of financial results on key performance indicators (e.g. gross profit margin ratio), covenants, and existing contracts (e.g. remuneration agreements). Entities may also need to consider if there are any further tax implications from the revised proposals. Stakeholder education may be necessary to explain changes to the financial statements.
3. Entities will need to consider the effects of the revised proposals as they negotiate new contractual arrangements and modify existing agreements.
4. The application of various aspects of the revised proposals will require judgment and estimation.

Effective date and early adoption

The Boards will not make a final decision on the effective date of the new standard until they complete their deliberations on the revised proposals in 2012. However, the Boards tentatively decided that the effective date of the proposed standard would not be earlier than for annual reporting periods beginning on or after 1 January 2015, with the IASB permitting early adoption. First-time adopters of IFRSs would also be permitted to apply the revenue recognition standard early.

Way forward

On 19 November 2011, the MASB issued the new MFRS Framework, which is an IFRS-compliant framework signifies the converging time line is coming to a close. By the time this Update reaches your desk, the reality of convergence begins.

The implication and impact of convergence are larger than we anticipate. From 1 January 2012 onwards, Malaysian entities will need to comply with all the accounting standards issued by the IASB without modifications. In other words, once a new standard is finalised and issued by the IASB, it will become mandatory in Malaysia.

With the increasing complexity of IFRSs as well as the increasing volume, there is always an uphill battle to keep up with the frequent changes in the accounting standards. For this reason, all the Malaysian stakeholders must actively engage in the due process in order to have our say as Malaysia is part of the international community. Malaysian stakeholders can no longer stay on the fence they must be proactive instead of reactive. It is in everybody's interest to work together to ensure our voice is heard.

To this end, we urge all stakeholders of the revised ED on revenue to send in your comments to the MASB without delay. In the interim, the affected entities should carry out the field test to ensure that the revised proposals do not cause any implementation or application concerns. It is only during the due process that we can make a difference and hence, let's put our effort together to implement the changes.

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