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Deloitte Luxembourg Newsletter on IFRS 15

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Welcome to this edition of the IFRS Newsletter prepared by the Deloitte Luxembourg IFRS Centre of Excellence with contributions from the professionals of our firm.

Considering the recent issuance of IFRS 15 *Revenue from Contracts with Customers*, we have decided to issue a separate Newsletter relating the upcoming revenue recognition requirements. IFRS 15 specifies how and when an entity applying IFRS has to recognise revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures. Moreover the standard defines revenue as income arising in the course of an entity's ordinary activities and provides a single, principles based five-step model to be applied to all contracts with customers.

IFRS 15 – IASB issues a new Standard on revenue recognition

IFRS 15 outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. It supersedes current revenue recognition guidance including IAS 18 Revenue, IAS 11 Construction Contracts and related Interpretations. The core principle is that an entity recognises 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 in exchange for those goods or services.

The Standard introduces far more prescriptive guidance than was included in IAS 18, IAS 11 and the related Interpretations and the majority of entities are likely to be affected by this, at least at some extent. Furthermore, the Standard may result in substantial changes to the timing of revenue recognition for some entities.

Entities will need to consider the extent to which changes, in some cases substantial, may be required to processes, IT systems and internal controls as a result both of the new model and the increased disclosure requirements. In this edition we also highlight key changes regarding the investment management sector, the real estate sector as well as the banking and securities sector.

The Standard is effective for reporting periods beginning on or after 1 January 2017 with early application permitted. Entities can choose to apply the Standard retrospectively or to use a modified transition approach. Please note that in the EU, the Standard first needs to be endorsed, before it can be applied. According to the latest EU endorsement status report of EFRAG, IFRS 15 is expected to be endorsed before its effective date.

For additional information on this topic and on services we could provide to your entity, contact us at **mailto:luifrsdesk@deloitte.lu**. Deloitte has a range of tools and publications to assist in implementing and reporting under IFRS.

We hope you find this issue useful. As always, we value and welcome your comments and feedback.

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History of IFRS 15 *Revenue from Contracts with Customers*

Background

Revenue is a crucial number to users of financial statements in assessing an entity's financial performance and position. However, revenue recognition requirements under IFRSs are different from those under US GAAP and both sets of requirements need improvement. US GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. Although IFRSs have fewer requirements on revenue recognition, the two main revenue recognition standards, IAS 18 Revenue and IAS 11 Construction Contracts, can be difficult to understand and apply. In addition, IAS 18 provides limited guidance on important topics such as revenue recognition for multiple-element arrangements.

Accordingly, the IASB and US Financial Accounting Standards Board (FASB) initiated a joint project to clarify the principles for recognising revenue and to develop a common revenue standard for IFRSs and US GAAP that would:

- remove inconsistencies and weaknesses in existing revenue requirements,
- provide a more robust framework for addressing revenue issues,
- improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets,
- provide more useful information to users of financial statements through improved disclosure requirements,
- simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

Project milestones

A Discussion Paper was issued in 2008, followed by an Exposure Draft (ED) in 2010, and a second ED in 2011. The final Standard is nearly fully converged. The main differences relate to interim disclosures, the collectability threshold for contracts, and timing of adoption. IFRS 15 was finally issued in May 2014 and applies to an annual reporting period beginning on or after 1 January 2017 with, nevertheless, being subject to EU endorsement.

The creation of a joint transition resource group (task force) was announced by IASB and FASB which will be responsible for informing the Boards about interpretive issues that could arise when companies, institutions, and other organisations implement the revenue recognition standard. It will solicit, analyse, and discuss stakeholder issues that apply to common transactions that could reasonably create diversity in practice. In addition to providing a forum to discuss the application of the requirements, the transition group will provide information that will help the Boards determine what, if any, action will be needed to resolve that diversity. The group itself will not issue guidance. Nevertheless, the Boards itself may issue additional guidance or interpretations before the Standard's effective date.

Application of IFRS 15 *Revenue from Contracts with Customers*

Superseded Standards

IFRS 15 replaces the following standards and interpretations:

- IAS 11 Construction contracts,
- IAS 18 Revenue,
- IFRIC 13 Customer Loyalty Programmes,
- IFRIC 15 Agreements for the Construction of Real Estate,
- IFRIC 18 Transfers of Assets from Customers and
- SIC-31 Revenue - Barter Transactions Involving Advertising Services.

Objective

The objective of IFRS 15 is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer. [IFRS 15:1] Application of the standard is mandatory for annual reporting periods starting from 1 January 2017 onwards. Earlier application is permitted.

Scope

The new revenue model applies to all contracts with customers except those that are within the scope of other IFRSs, such as leases, insurance contracts and financial instruments [IFRS 15:5]. Transfers of assets that are not related to the entity's ordinary activities (such as sale of property, plant and equipment, real estate or intangible assets) will also be required to follow some of the recognition and measurement requirements of the new model.

The recognition of interest and dividend income are not in scope of the new Standard. Furthermore, the new Standard does not apply to non-monetary exchanges between entities in the same line of business where this is done to facilitate sales to customers, or potential customers.

A contract with a customer may be partially within the scope of IFRS 15 and partially within the scope of another standard. In that scenario: [IFRS 15:7]

- if other standards specify how to separate and/or initially measure one or more parts of the contract, then those separation and measurement requirements are applied first. The transaction price is then reduced by the amounts that are initially measured under other standards;
- if no other standard provides guidance on how to separate and/or initially measure one or more parts of the contract, then IFRS 15 will be applied.

An entity may contract with a counterparty to participate in an activity or process in which the parties to the contract share the risks and benefits resulting from that activity or process, often referred to as a 'collaborative arrangement'. Where this is the case, the entity will have to assess whether the other entity is its 'customer' in order to establish whether the transactions with the other entity are within the scope of the new Standard.

Key definitions

'Contract' and the 'customer' are defined terms in the Standard. The new revenue model that has been adopted by the IASB requires that there is a **contract which gives rise to enforceable rights and obligations**. The Standard sets out criteria that must be met for this to be the case. A 'customer' is not any counterparty, but rather one that has contracted to acquire goods or services that are an output of the entity's ordinary activities in exchange for consideration. In some cases, careful consideration may be required to assess whether a contract is in the scope of IFRS 15, particularly for collaborative arrangements.

Appendix A of IFRS 15 provides the following key definitions:

Contract	An (oral) agreement between two or more parties that creates enforceable rights and obligations.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.
Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants
Performance Obligation	A promise in a contract with a customer to transfer to the customer either: • a good or service (or a bundle of goods or services) that is distinct; or • a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
Revenue	Income arising in the course of an entity’s ordinary activities.
Transaction price	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Accounting requirements for revenue – The five-step model framework

Overview of the new revenue model:

The core principle is that an entity recognises 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 in exchange for those goods or services. The Standard is to be applied on an **individual contract basis**. However, a portfolio approach is permitted provided it is reasonably expected that the impact on the financial statements will not be materially different from applying the Standard on an individual contract basis.

The steps to be applied in the model are as follows:

Entities should consider the details of the new revenue model carefully, and not rely on previous analysis, as previous conclusions as to the effects of the model on their business may no longer be appropriate.

Step 1:

A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met: [IFRS 15:9]

- the contract has been approved by the parties to the contract;
- each party's rights in relation to the goods or services to be transferred can be identified;
- the payment terms for the goods or services to be transferred can be identified;
- the contract has commercial substance; and
- it is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.

If a contract with a customer does not yet meet all of the above criteria, the entity will continue to re-assess the contract going forward to determine whether it subsequently meets the above criteria. From that point, the entity will apply IFRS 15 to the contract. [IFRS 15:14]

The standard provides detailed guidance on how to account for approved contract modifications. If certain conditions are met, a contract modification will be accounted for as a separate contract with the customer. If not, it will be accounted for by modifying the accounting for the current contract with the customer. Whether the latter type of modification is accounted for prospectively or retrospectively depends on whether the remaining goods or services to be delivered after the modification are distinct from those delivered prior to the modification. Further details on accounting for contract modifications can be found in the Standard. [IFRS 15:18-21].

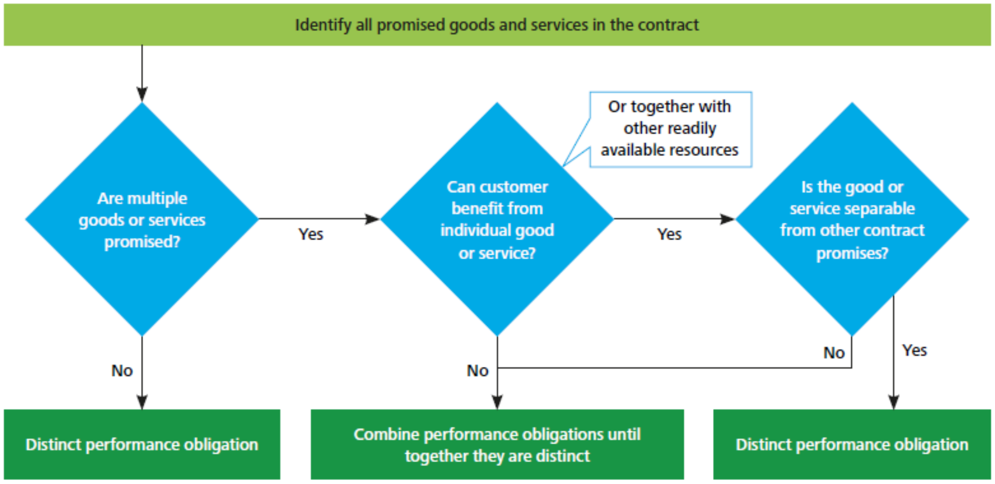
Step 2:

Step 5 (see below) requires that revenue should be recognised when, or as, the entity satisfies a performance obligation. It is therefore necessary first to identify the distinct performance obligations (sometimes called "unbundling"), and this is done at inception of a contract. Distinct performance obligations are goods or services promised in a contract that satisfy both of the following conditions:

- the customer can **benefit from the good or service** either on its own or in combination with other resources available to the customer (i.e. it is capable of being distinct); and
- the entity's promise to transfer the good or service to the customer is **separately identifiable from other promises** in the contract (i.e. it is distinct in the context of the contract).

In addition, if certain criteria are met, the Standard requires a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer to be regarded as a single performance obligation.

How to identify the distinct performance obligations in a contract?



Applying the second condition — i.e. determining whether a promised good or service is separately identifiable from other promises in a contract — requires analysis of the contract terms and consideration of the specific facts and circumstances. Factors indicating that a promised good or service is separately identifiable from other promises include:

- the entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output;
- the good or service is not significantly modifying or customising another good or service promised in the contract;
- the good or service is not highly dependent on, or highly interrelated with, other promised goods or services in the contract.

A delivered good or service may not be distinct if it cannot be used without another good or service that has not yet been delivered – even if the second good or service would be distinct if it were delivered first.

Step 3:

An entity must determine the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract in order to recognise revenue. The transaction price can be a fixed amount or it can vary because of discounts, rebates, price concessions, refunds, credits, incentives, performance bonuses, and other similar items. An entity estimates the transaction price by considering the effect of variable consideration, the time value of money (if a significant financing component is deemed to exist), non-cash consideration, and consideration payable to the customer. Entities should estimate the transaction price using either a probability-weighted approach (expected value) or an approach based on the single most likely amount — whichever is more predictive of the amount to which the entity expects to be entitled.

'Variable consideration' is wider than just consideration triggered by events outside the seller's control (sometimes referred to as contingent consideration). Variable consideration encompasses any amount that is variable under a contract, including, for example, performance bonuses or penalties, discounts and the customer's right to return goods.

Variable consideration is only included in the transaction price if, and to the extent that, it is highly probable that its inclusion will not result in a "significant revenue reversal" in the future as a result of re-estimation. A significant revenue reversal occurs when a subsequent change in the estimate of variable consideration results in a significant reduction to the cumulative amount of revenue recognised from the customer. This constraint may have an impact when:

- the amount of consideration is susceptible to factors outside the entity's influence (e.g. volatility in a market, the judgement of third parties, or a high risk of obsolescence);
- the uncertainty is not expected to be resolved for a long period of time; or
- there is limited prior experience with similar performance obligations or there is a broad range of possible consideration amounts.

If an entity concludes, because of the potential for a significant revenue reversal, that it is not appropriate to include all of the variable consideration in the transaction price, it should assess whether it is instead appropriate to include part of the variable consideration, i.e. a lower amount. That lower amount of variable consideration should be included in the transaction price if it passes the constraint assessment (i.e. it is highly probable that there will not be a significant revenue reversal based on inclusion of that lower amount).

Under the new model, revenue reflects the amount to which an entity expects to be entitled under a contract with a customer, rather than the amount it expects actually to collect. However, if an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract with the customer (i.e. it may grant a further discount or price concession), perhaps based on past business practice, the entity would initially estimate revenue at the lower amount and assess the collectability of that lower amount (see Step 1). Subsequently, if there is evidence to suggest that revenue already recognised is not collectable, the Standard **requires impairment losses** to be presented separately as an expense in profit or loss.

When a contract contains a significant financing component, the effects of the time value of money are taken into account by **adjusting the transaction price** and **recognising interest income or expense** over the financing period, as relevant. This is not required if the time period between the transfer of goods or services and payment is less than one year. Please note that this might affect the amount of revenue which first will be lower, and higher in future, which – in return – might have an impact on EBITDA.

Step 4:

When a contract contains more than one distinct performance obligation, an entity allocates the transaction price

to each distinct performance obligation on the basis of relative stand-alone selling price.

The best evidence of stand-alone selling price is the price at which the good or service is sold separately by the entity. If that is not available, an entity is required to estimate the stand-alone selling price by using an approach that maximises the use of observable inputs (e.g. adjusted market assessment, expected cost plus a margin, or — in certain limited circumstances — using a residual approach).

Where the transaction price includes a variable amount, consideration needs to be given as to whether that variable amount relates to all or only some of the performance obligations in the contract. Unless the criteria in the Standard for treating the variable amount as relating only to specific performance obligations are met, the variable amount should be allocated across all of the performance obligations in the contract.

For some entities this will be a major practical issue when implementing the Standard. The new requirements may require a **separate calculation and allocation exercise to be performed for each contract**, which will be particularly challenging for entities with a very large number of different contracts. For example, for telecom operators, a mobile telephone contract typically bundles together the handset and subsequent services (e.g. connectivity to the network). Under the requirements of the new Standard it will be necessary to allocate the transaction price (i.e. the amount payable by the customer under the contract) to the distinct performance obligations, typically separating the initial delivery of the handset from the provision of network services. If an operator has a very large number of differently priced contracts, it may be necessary to consider systems changes in order to cope with the volume of calculations required.

Step 5:

A performance obligation is satisfied when **control of the underlying goods or services** (the "assets") **for the particular performance obligation is transferred** to the customer. "Control" is defined as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" underlying the good or service. This **differs from the approach under IAS 18** where, for example, revenue in respect of goods is recognised when the significant risks and rewards of ownership of the goods are transferred to the customer.

The definition of control includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to: [IFRS 15:31-33]

- using the asset to produce goods or provide services;
- using the asset to enhance the value of other assets;
- using the asset to settle liabilities or to reduce expenses;
- selling or exchanging the asset;
- pledging the asset to secure a loan; and
- holding the asset.

Furthermore, under IAS 18 different guidance is provided on when to account for revenue depending on whether a good or a service is being supplied to the customer. The new Standard takes a **different approach** to assess whether revenue should be **recognised at a point in time <u>or</u> over time**, through consistent guidance that applies equally to sales of goods and of services.

An entity recognises revenue **over time** if one of the following criteria is met: [IFRS 15:35]

- the customer simultaneously receives and consumes all of the benefits provided by the entity as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created; or
- the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Whether an entity recognises revenue over the period during which it manufactures a product or on delivery to the customer will depend on the specific terms of the contract. For example, with some contract manufacturing, an entity will be required to recognise revenue during production (rather than upon delivery) of the components if the products have no alternative use and the contract does not allow the customer to avoid paying for the manufacturing work performed by the entity.

If an entity does not satisfy its performance obligation over time, it satisfies it at a **point in time**. Revenue will therefore be recognised when control is passed at a certain point in time. Factors that may indicate the point in time at which control passes include, but are not limited to: [IFRS 15:38]

- the entity has a present right to payment for the asset;
- the customer has legal title to the asset;
- the entity has transferred physical possession of the asset;
- the customer has the significant risks and rewards related to the ownership of the asset; and
- the customer has accepted the asset.

For revenue that is recognised at a point in time, IFRS 15 seeks to identify the point at which control transfers to the customer, whereas IAS 18 focuses instead on the point at which risks and rewards are transferred. As a consequence, the **timing of revenue recognition** may change for some 'point in time' transactions when the new Standard is adopted.

Costs relating to a contract

The incremental **costs of obtaining a contract** must be recognised as an asset if the entity expects to recover those costs. However, those incremental costs are limited to the costs that the entity would not have incurred if the contract had not been successfully obtained (e.g. ‘success fees’ paid to agents). A practical expedient is available, allowing the incremental costs of obtaining a contract to be expensed if the associated amortisation period would be 12 months or less [IFRS 15:91-94].

Costs incurred to fulfil a contract are recognised as an asset when and only when they relate directly to a contract, generate or enhance resources that will be used to satisfy performance obligations, and are expected to be recovered (unless the costs to fulfil a contract are within the scope of other IFRSs, in which case the requirements of those other IFRSs apply) [IFRS 15:95]. These include costs such as direct labour, direct materials, and the allocation of overheads that relate directly to the contract [IFRS 15:97].

Implementation guidance in relation to applying IFRS 15

The new Standard provides some detailed guidance to assist entities in applying the Standard in certain areas, some of which differs from the previous accounting applied under IAS 18. In particular:

Warranties — where an entity grants a warranty to a customer, the nature of that warranty will determine the accounting impact. Where the customer can choose whether or not to purchase the warranty, or the warranty provides the customer with an additional service, it will be accounted for as a distinct performance obligation. A warranty that merely provides assurance that the item supplied meets the agreed-upon specifications will not be accounted for as a distinct performance obligation;

Customers' unexercised rights — in some circumstances, customers are not expected to claim all the goods or services to which they have become entitled: a common example is unclaimed loyalty points. The failure by customers to exercise all of their rights under a contract is referred to as 'breakage'. When a level of breakage is expected, the associated amounts paid are treated as variable consideration and recognised as revenue in proportion to the pattern of rights expected to be exercised by the customer (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). In scenarios in which a level of breakage is not initially expected, an entity will recognise revenue associated with breakage amounts only when the likelihood of the customer exercising its remaining rights becomes remote;

Customer options for additional goods or services — some contracts include an option for the customer to purchase additional goods or services at a discount. Where this represents a 'material right' for the customer (e.g. the option gives the customer the right to acquire additional goods at a substantial discount), an entity must allocate a portion of the transaction price to the option and recognise revenue when control of the additional goods or services associated with the option is transferred to the customer, or when the option expires; and

Licensing — the Standard requires an entity to assess the nature of a promised license over intellectual property, and specifically whether the license gives the customer the "right to use" or "right to access" the entity's intellectual property. The boards decided to emphasise that a company should consider the requirements related to identifying performance obligations **before determining** when a licence transfers to a customer. That is because when a licence is not distinct, the company should recognise revenue when the bundle of goods or services (which includes the licence) transfers to a customer. If a licence is distinct, IFRS 15 specifies that the timing of revenue recognition depends on whether the licence provides the customer with a right to:

- **access** the company’s intellectual property as it exists throughout the licence period (in which case, the licence transfers to the customer over time, hence, the performance obligation is satisfied over time); or
- **use** the company’s intellectual property as it exists at the point in time the licence is granted (in which case, the licence transfers at a point in time and, hence, revenue is recognised at that time).

The Standard **includes criteria** to determine whether a license is a right to access the intellectual property. If these criteria are not met, the licence represents a right to use an entity's intellectual property. The application of these criteria is critical in determining the manner in which revenue related to such licenses is recognised.

Presentation in financial statements

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset, or a receivable, depending on the relationship between the entity's performance and the customer's payment. [IFRS 15:105]

A contract liability is presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity performing by transferring the related good or service to the customer. [IFRS 15:106]

Where the entity has performed by transferring a good or service to the customer and the customer has not yet paid the related consideration, a contract asset or a receivable is presented in the statement of financial position, depending on the nature of the entity's right to consideration. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time, for example future performance of the entity. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time.

Please note that, depending on the nature of each single contract, the corresponding classification as short-term or long-term liability respectively as receivable will impact the working capital of a company.

When finally endorsed by the EU contract assets and receivables shall be accounted for in accordance with IFRS 9. Any impairment relating to contracts with customers should be measured, presented and disclosed in accordance with IFRS 9. Any difference between the initial recognition of a receivable and the corresponding amount of revenue recognised should also be presented as an expense, for example, an impairment loss. [IFRS 15:107-108] If IFRS 9 is not endorsed as at the effective date of IFRS 15 companies will have to fall back on IAS 39 accordingly.

Disclosures

The disclosure objective stated in IFRS 15 is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The Standard significantly expands the current disclosure requirements about revenue recognition. The required disclosures include:

- a disaggregation of revenue to "depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors";
- certain information about changes in contract balances, e.g. opening and closing balances of receivables, contract assets and liabilities, revenue recognised in the current period that was previously included in the contract liability balance and revenue recognised in the current period that relates to performance obligations satisfied in a prior period;
- for contracts that are expected to extend beyond one year, the aggregate amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognise that revenue;

- information about assets recognised for costs to obtain or fulfil a contract;
- qualitative descriptions of the types of goods or services, significant payment terms and typical timing of satisfying obligations of an entity's contracts with customers;
- a description of the significant judgements about the amount and timing of revenue recognition;
- policy decisions made by the entity related to the time value of money and costs to obtain or fulfil a contract; and
- information about the methods, inputs and assumptions used to determine the transaction price and to allocate amounts to performance obligations.

In order to achieve the disclosure objective stated above, the Standard introduces a number of new disclosure requirements. Further detail about these specific requirements can be found at IFRS 15:110-129.

Preparation for the impacts

Although the effective date of the Standard is still several years away, the Boards have set this date recognising that some entities will need all of the intervening period to transition to the new requirements. In particular, entities may need to change systems and processes, and to run two sets of systems concurrently in order to meet the transition requirements. Besides potential IT-system changes regarding a retrospective adoption, additional qualitative and quantitative disclosure requirements, corresponding trainings for the accountants have to be considered.

In addition to preparing the market and educating their investors and analysts on the impact of the new Standard, entities will need to consider the wider implications of changes to the timing of revenue recognition and, hence, profits. Amongst others, these may include:

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

Current accounting processes may require changes to cope with the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas. IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard may require modifications to existing accounting processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes. In Luxembourg this is especially important regarding the investment management sector as well as the real estate sector. The impacts on these sectors will be highlighted in the following.

Implications for the investment management sector

In the following we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the investment management sector and then consider significant parts of the new Standard that may contribute to those impacts. Of course many more complexities exist.

When should variable or uncertain revenues be recognised?

Contracts in the investment management sector will often include significant variable elements, such as performance bonuses or penalties. For example, a performance bonus may be payable if and when certain conditions are met, or based on net assets under management. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals as a result of subsequent re-estimation. This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, whilst many entities in the sector will already follow this type of approach, in certain scenarios, a significant degree of judgement will be required 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.

When should 'upfront' fees be recognised?

In the investment management sector, it is common for entities to receive an initial 'sign-on' fee. New detailed guidance may lead to a change in practice when accounting for such fees. Unless control of distinct goods and services is transferred to the customer at the outset, an upfront fee should be regarded as an advance payment for future goods and services and should be recognised as revenue when those future goods and services are provided. Often, upfront fees are charged in order to cover initial sign-up costs, but this is not in itself sufficient to justify upfront revenue recognition.

Should contract costs be capitalised?

In addition to more prescriptive guidance on revenue recognition, the new Standard introduces specific criteria for determining whether to capitalise certain costs, distinguishing between those costs associated with obtaining a contract (e.g. sales commissions) and those costs associated with fulfilling a contract. In the investment management sector, this becomes an issue because significant costs are incurred that are directly attributable to obtaining contracts with customers, for example through 'success fees' (i.e. commissions that are only payable if a contract is obtained). At present, different entities might treat these costs differently.

The new Standard will require entities to capitalise success fees, which will have an impact on operating profits. In addition, the new Standard requires capitalised contract costs to be amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services. Entities will need to exercise judgement to determine the appropriate basis and time period for this amortisation.

Implications for the real estate sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the real estate sector and then consider significant parts of the new Standard that may contribute to those impacts. Of course many more complexities exist.

Property developers and construction companies

Should revenue be recognised over time or at a point in time?

As already mentioned above, IFRS 15 introduces a new approach to determine whether revenue should be recognised over time or at a point in time.

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

This guidance is different from, and much more specific than, that previously included in IFRSs, and some entities may find that revenue previously recognised at a point in time should now be recognised over time, or vice versa. For example, revenue **from an off- plan sale of real estate** may be affected by the new Standard. Whether revenue should be recognised over time or at a point in time **will often depend on a careful analysis of specific contract terms**. Quite small differences between otherwise similar contracts could potentially have a fundamental impact on the timing of revenue recognition. In determining whether revenue on such sales is recognised at a point in time or over time, particular care will need to be given to whether the entity could have an alternative use for the asset under construction and the entitlement of the entity to be paid for the work performed to date.

It will often be particularly important to focus on any contractual terms allowing the customer to cancel, curtail or significantly modify the contract and whether, if such circumstances arose, the seller would always be contractually entitled to adequate compensation for work performed to date. Assessment of these factors, and others, will need to be made in the context of both the contract terms and the local legal environment.

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

How are different goods and services within a contract identified?

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

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

Should contract costs be capitalised?

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

Should revenue be adjusted for the effects of the time value of money?

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

What is the impact if a contract is modified?

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

Property managers

When should variable or uncertain revenues be recognised?

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

Implications for banking and securities sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the banking and securities sector and then consider significant parts of the new Standard that may contribute to those impacts. Of course many more complexities exist.

What type of revenue is impacted by the new Standard?

IFRS 15 only specifies how to account for revenue which arises as a result of contracts from customers; moreover, certain contracts with customers are scoped out because they are dealt with in other Standards. Interest income and dividend income, which were within the scope of the previous revenue standard, will now be within the scope of the financial instruments standard, but it is not expected that this will impact the accounting for such income streams.

How should an entity identify and allocate revenue to different goods and services?

The new Standard requires the revenue from a contract to be allocated to each distinct good or service provided on a relative standalone selling price basis, though a 'residual' approach is permitted in limited circumstances. The previous revenue standard included detailed guidance for banking entities in respect of how to treat the receipt of various types of fee, and entities will need to consider whether any changes are required to the treatment of such fees in respect of identifying separate goods and services under IFRS 15.

This may result in practical implementation issues in the banking and securities sector where services are often integrated. Customers may be charged for a number of services; for example, investment banks involved in a merger and acquisitions transaction may offer a number of services within the same contract such as identifying a target, performing due diligence, structuring the deal and arranging financing. Where it is concluded that certain elements should be accounted for separately, entities will then typically look to the standalone selling price to apportion the relevant amount of the transaction price to each distinct element in the contract.

When should 'upfront' fees be recognised?

An upfront fee should be regarded as an advance payment for future services and so should be recognised as revenue when those future services are provided. Often, upfront fees are charged in order to cover initial sign-up costs, but this is not in itself sufficient to justify upfront revenue recognition. The same logic would apply to any additional fees (e.g. fees associated with particular transactions) that may be charged during the term of a contract. It will be necessary to consider whether these relate to distinct services; if they are not separate from the original service provided, they may result in variable consideration relating to the overall banking services.

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