In depth
A look at current financial reporting issues

Revenue from contracts with customers
The standard is final – A comprehensive look at the new revenue model

Real Estate industry supplement

At a glance
On 28 May 2014, the IASB and FASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the change. The effect on entities will vary depending on industry and current accounting practices. However, almost all entities will see a significant increase in required disclosures.

The PwC guide Revenue from Contracts with Customers, 2016 is a comprehensive analysis of the new standard. This supplement highlights some of the areas that could pose the most significant challenges for real estate managers and developers as they transition to the new standard. This supplement should also be read in conjunction with our supplements for the Engineering and Construction and Asset Management industries.

Overview
IFRS 15, Revenue from contracts with customers (“IFRS 15” or “the new standard”) will replace existing revenue recognition guidance under IFRS and US GAAP. IAS 11, Construction contracts, and IAS 18, Revenue have both been withdrawn and replaced by a single new model based on the principle that revenue is recognised when control is transferred to the customer. The transition to a new model also means that other IFRICs and SICs will be withdrawn. The withdrawal of IFRIC 15, Agreements for the construction of real estate, is likely to be of particular relevance to real estate developers who relied on this guidance to determine if the sale of real estate is accounted for as a good or service. This distinction had the impact of determining whether the revenue was recognised once the risks and rewards had transferred or on a continuous basis as constructed.
This supplement provides an initial analysis of key questions and issues facing the industry for both real estate managers and developers in each of the sections below. These issues will continue to evolve as entities address the challenges of implementation, and the examples and related discussions herein are intended to highlight areas of focus to assist entities in evaluating the implications of the new standard.
**Scope**

The new standard applies to all contracts with customers, excluding leases, insurance contracts, financial instruments (including financial guarantee contracts) and contractual arrangements in the scope of other guidance. A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. A contract does not exist if both parties have the unilateral right to terminate a wholly unperformed contract without penalty.

Lease contracts are scoped out of IFRS 15, and are instead accounted for under IAS 17/IFRS 16, *Leases*. An arrangement between a lessor and a lessee under which property is leased, and additional services are provided by the lessor is bifurcated into two elements, so that IAS 17/IFRS 16 is applied to the lease income, and IFRS 15 is applied to the service revenue earned. The hierarchy applied is that IFRS 16 is applied first, and the residual is allocated to IFRS 15.

IFRS 15 applies only to contracts with customers. In simple terms, a customer is the party that purchases an entity’s goods or services. Identifying the customer is straightforward in many instances, but a careful analysis needs to be performed in other situations to confirm whether a customer relationship exists. Entities that enter into arrangements where the parties jointly participate in an activity to share the risks and benefits (a collaborative arrangement) will need to evaluate if the arrangement is a contract with a customer in the scope of IFRS 15. For example, a contract with a counterparty to develop an asset where both parties share in the risks and benefits might not be in the scope of the revenue guidance because the counterparty is unlikely to meet the definition of a customer. An arrangement where, in substance, the entity is selling a good or service is likely in the scope of the revenue standard, even if it is termed a ‘collaboration’ or something similar.

Where these transactions are considered to be outside of the scope of IFRS 15, the parties will need to assess the substance of the arrangement to determine the most appropriate manner of recording the transaction.

<table>
<thead>
<tr>
<th>New standard</th>
<th>Current IFRS</th>
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<tbody>
<tr>
<td><strong>Contracts within the scope of IFRS 15</strong></td>
<td>The existing revenue guidance also scopes out, amongst others, lease agreements and insurance contracts within the scope of IFRS 4. There is no specific guidance on the separation of contracts but, in practice, separate components of a transaction are generally dealt with under the different standards where applicable.</td>
</tr>
<tr>
<td>IFRS 15 applies to all contracts with customers, excluding leases, insurance contracts, financial instruments (including financial guarantee contracts) and contractual arrangements in the scope of other guidance. Some contracts include components that are in the scope of IFRS 15 and other components that are in the scope of other standards. Only elements not covered by another standard fall within the scope of IFRS 15. An entity should first apply the separation or measurement guidance in other applicable standards (if any) and then apply the guidance in the new standard to the remaining consideration and performance obligations.</td>
<td></td>
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</table>
Potential impact:

**Real estate management and real estate development:**

The accounting for a contract that includes components that are in the scope of IFRS 15 and other components that are in the scope of the leasing standard does not differ from current guidance. The leasing guidance will continue to be used to separate leases from service contracts. For example, this means that a real estate manager would account for the lease element under IAS 17/IFRS 16 and the maintenance revenue under IFRS 15. IFRS 15, however, provides the relevant guidance on how the consideration is allocated between these components.

Another intersection between the leases and revenue standards occurs in considering the accounting for a sale and leaseback transaction. The accounting for sale and leaseback transactions under IAS 17 mainly depends on whether the leaseback is classified as a finance or an operating lease. Under IFRS 16, the determining factor is whether the transfer of the asset qualifies as a sale in accordance with IFRS 15. An entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to make this assessment.

From a real estate development perspective, the new scope requirements are not expected to have a significant impact as many contracts will only consist of elements that continue to be accounted for in accordance with the revenue guidance.
**Identify the contract(s) with the customer**

The new standard requires an entity to identify the contract with the customer. A contract can be written, verbal or implicit. An entity will identify the customer and assess at the inception of the contract whether the parties to the contract are committed to perform their respective obligations and it is probable that the entity will collect the consideration. The collectability assessment is based on the customer’s ability and intent to pay as amounts become due. This assessment determines whether a contract exists for the purpose of applying the new standard. In addition, the new standard includes specific guidance on contract combination.

If the criteria for the existence of a contract is not met at inception, consideration received from a customer is recognised as a liability where a contract with a customer does not meet the criteria and an entity receives consideration from the customer. The entity recognises the consideration received as revenue only when the entity has no remaining obligations to transfer goods or services to the customer, and all (or substantially all) of the consideration promised by the customer has been received by the entity and is non-refundable, or the contract has been terminated, and the consideration received from the customer is non-refundable. The entity shall continue to assess the contract to determine whether the criteria are subsequently met. If the criteria are met and goods or services have been transferred to the customer, a cumulative catch adjustment is made to recognise the applicable revenue.

Contract modifications are common in the real estate development industry. Contract modifications might need to be accounted for as a new contract, or combined and accounted for together with an existing contract.

**Accounting for contract modifications under the new standard**

<table>
<thead>
<tr>
<th>Modification</th>
<th>Required accounting treatment</th>
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<tbody>
<tr>
<td>Modification adds additional distinct performance obligations priced at their stand-alone selling price</td>
<td>The modification is treated like a new contract (Prospective)</td>
</tr>
<tr>
<td>At modification date, remaining performance obligations are distinct from those already transferred, but not priced at stand-alone selling price</td>
<td>The old contract is treated as cancelled. The remaining and new performance obligations are treated as a new contract and are accounted for prospectively.</td>
</tr>
<tr>
<td>At the modification date, remaining performance obligations are NOT distinct from those already transferred</td>
<td>The revenue is adjusted on a cumulative catch-up basis, on the date of the modification.</td>
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</table>

**New standard**

**Contract combination:**

Contracts entered into at or near the same time, with the same customer (or related party of the customer) shall be combined if (i) they are negotiated as a package, (ii) the amount of consideration to be paid in one contract

**Current IFRS**

There is limited guidance under IAS 18 for when contracts should be combined and separated. The assessment is based on the substance of the transactions. IAS 11, *Construction contracts*, contains detailed guidance on when to segment and when to combine construction contracts based on the nature of the agreement with the customer and how the arrangement was negotiated.
depends on the price or performance of the other contract, or (iii) the services in the contracts represent a single performance obligation.

**Contract modifications (for example, change orders, variations or amendments)**

An entity will account for a modification if the parties to a contract approve a change in the scope and/or price of a contract. If the parties have approved a change in the scope, but have not yet determined the corresponding change in price (for example, where change has been agreed upon but the parties have not yet agreed on the pricing (unpriced change orders)), the entity should estimate the change to the contract price using the principles applied to variable consideration.

A contract modification is accounted for as a separate contract if:

- the modification promises distinct goods or services that result in a separate performance obligation; and
- the new items are priced at their stand-alone selling prices.

An example of this might be that a construction company is contracted to construct a building. This contract is then amended by requiring the construction company to build additional structures. The additional structures are priced at their stand-alone selling price.

A modification that is not a separate contract is accounted for either as:

- A prospective adjustment if the goods or services in the modification are distinct from those transferred before the modification. The remaining consideration in the original contract is combined with the consideration promised in the modification to create a new transaction price that is then allocated to all remaining performance obligations.
- A cumulative adjustment to contract revenue if the remaining goods and services are not distinct and are part of a single performance obligation that is partially satisfied.

Many real estate development contracts fall under IAS 18, ‘Revenue’ because of the guidance in IFRIC 15, *Agreements for the construction of real estate.*

Current IFRS contains limited guidance on the accounting for priced or unpriced modifications. IAS 11 requires that a modification for construction contracts in the form of a change order or variation is generally included in contract revenue when it is probable that the change order will be approved by the customer and the amount of revenue can be reliably measured.
Example – Unpriced change orders

Facts: A developer has a single performance obligation to build an office building. The developer has a history of executing unpriced change orders; that is, those change orders where price is not defined until after scope changes are agreed upon. Scope changes usually do not provide additional distinct goods or services to the customer. In this example the change order does not provide distinct goods or services because the promises are highly interrelated with the goods or services in the original contract, and are part of the contractor’s service of integrating those goods and services into a combined item for the customer. Prices are negotiated in the context of the customer’s overall objective to obtain a building. It is not uncommon for the developer to commence work once the parties agree to the scope of the change, but before the parties agree on the price.

When would these unpriced change orders be included in contract revenue?

Discussion: The developer should account for the unpriced change order as variable consideration (see page 10) after the scope changes are approved. The consideration is considered to be variable since, even though the scope change has been approved, the price is as yet undetermined. Since the consideration is variable, the developer will need to consider the criteria relating to recognition of variable consideration. The developer will therefore consider the amount for which it is highly probable that there will be no significant subsequent reversal in the cumulative amount of revenue recognised.

The developer will also need to determine whether the unpriced change order results in additional goods and services that should be accounted for as a separate contract. The developer in this case will update the transaction price and measure of progress toward completion of the contract (that is, a cumulative catch-up adjustment) because the remaining goods or services, including the change order, are not distinct and are part of a single performance obligation that is partially satisfied.

Potential impact:

Real estate developers:
The new standard provides more guidance in an area where practice might previously have been mixed. Management will need to apply judgement when evaluating whether goods or services in a modification are distinct, and whether the price change reflects the stand-alone selling price to determine the accounting. This might be more challenging in situations where there are multiple performance obligations in a contract, or when modifications occur frequently.

Real estate managers:
Real estate managers may structure their arrangements such that services and fees are in different contracts. These contracts may meet the requirements to be accounted for as a combined contract when applying the new standard. Combining contracts does not necessitate that there is a single performance obligation (see page 7); however, if there is more than one performance obligation, the entity would need to look at the pricing of both contracts in total and allocate the consideration between the multiple performance obligations.
### Identification of performance obligations

A key question that affects the timing of revenue recognition is whether the seller has promised one or multiple performance obligations to the customer. A performance obligation is a promise to transfer a distinct good or service (or a series of distinct goods or services that are substantially the same and have the same pattern of transfer) to a customer.

IAS 18 required an entity to apply the revenue recognition criteria to each separately identifiable component of a single transaction, but contained little guidance about how to determine the components. IFRS 15 provides more guidance in the identification of performance obligations, and requires entities to identify all of the promises in a contract and to determine whether those obligations are distinct. Performance obligations that are considered to be distinct are accounted for separately.

<table>
<thead>
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<tr>
<td>A performance obligation is a promise in a contract to transfer to a customer either:</td>
<td>IAS 18 contains little specific guidance on separating and combining contractual elements.</td>
</tr>
<tr>
<td>• a good or service (or a bundle of goods or services) that is distinct; or</td>
<td>The revenue recognition criteria are applied separately to each transaction. It might be necessary to separate a transaction into identifiable components to reflect the substance of the transaction in certain circumstances. Common practice has been to separate when appropriate when identifiable components have stand-alone value and their fair value can be measured reliably.</td>
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<tr>
<td>• a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.</td>
<td>Two or more transactions might need to be grouped together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.</td>
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A good or service is distinct if both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (for example, because the entity regularly sells the good or service separately).
- The good or service is separately identifiable from other goods or services in the contract.

Factors that indicate that a good or service in a contract is not separately identifiable include, but are not limited to:

- The entity provides a significant service of integrating the goods or services promised in the contract into a combined output(s) for which the customer has contracted.
- The good or service does significantly modify or customise another good or service promised in the contract.
• The good or service is highly interdependent on, or highly interrelated with, other promised goods or services.

Goods and services that are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services that is distinct.

Potential impact:

**Real estate management:**
The management entity is often entitled to several different fees. The new standard will require a manager to consider whether the services should be viewed as a single performance obligation, or whether some of these services are ‘distinct’ and should therefore be treated as separate performance obligations. Multiple fees do not always correlate to multiple distinct promises in the contract.

An example of this is that real estate managers sometimes receive upfront fees as well as fees over the course of their contract. In these instances the entity will need to consider what the distinct performance obligations are, and whether a distinct performance obligation is satisfied upfront. This is likely to be an area of judgement.

The new standard requires an entity to assess the services promised in a contract with a customer and identify those services that are distinct as performance obligations. A service is distinct if it meets the criteria discussed above. If a service is not distinct, the entity must combine the services until such a point that a bundle of services is viewed as distinct. In some cases, this will result in all services being combined into a single performance obligation. The customer’s perspective should be considered when assessing whether a promise gives rise to a performance obligation.

In this instance the entity must consider if the upfront fee that the manager received as a construction fee and transaction bonus includes a management fee that may need to be considered to be a separate performance obligation. The second assessment that the real estate manager needs to make is whether to recognise the revenue immediately (at a point in time) or over time, for each of the identified performance obligations, as discussed below.

**Real estate developers:**
Developers often account for each contract at the contract level under IAS 11 or IAS 18; that is, contractors account for the ‘macro-promise’ in the contract (for example, to build a hotel). Current guidance permits this approach, although a contractor effectively promises to provide a number of different goods or services in delivering such macro-promises. Determining when to separately account for these performance obligations under the new standard will require judgement. It is possible to account for a contract at the contract level (for example, the macro-promise to build a hotel) under the new standard when the criteria for combining a bundle of goods or services into one performance obligation are met. However, in some cases, there might be additional distinct performance obligations that need to be identified (for example, constructing a golf courses). Revenue would then be allocated to that distinct performance obligation and recognised only when that obligation is satisfied. Judgement will be needed in many situations to determine if all of the promises in the contract should be bundled together, particularly when assessing contracts such as engineering, procurement, and construction (EPC) or design / build contracts.
Developers will often construct amenities (for example, a communal gym in a housing development) that will eventually be legally owned by a separate organisation representing the homeowners (for example, a home owners association). The amenities are promised implicitly or explicitly to the homeowners. In such cases, the homeowners are considered to be the customer for the amenities. This is because the amenities are a promise to the homeowners in the context of the contract. The entity needs to assess whether the amenities represent a separate performance obligation. The pattern of revenue recognition will depend on the identification of the performance obligations, (that is, whether the amenities were distinct from the residential units) and whether the criteria were met for performance obligations satisfied over time.

Some developers consider the sale of the land, infrastructure and completed building to be separate components, and accordingly recognise revenue when each of these ‘components’ has been delivered. This may not necessarily be the case under IFRS 15. Judgement will be needed in many situations to identify distinct performance obligations.

**Example – Sale of serviced land**

**Facts:** A developer is developing homogeneous units and sells either individual homes constructed on a plot of land, or just the undeveloped plots, to separate customers. The homes/plots are sold with a promise to complete certain amenities (for example, a school, roads, connection to utilities and/or a club house). Sometimes the developer will offer a choice as to whether the customer wants just the plot of land with the promised services (so the customer can use a separate builder to construct the house) or a house on the plot.

**Discussion:** Each of the promises in these arrangements (land, amenities and house) is likely to meet the requirement that a customer can benefit from them on their own or in conjunction with other goods or services available in the market. The question is whether they are separately identifiable promises. Whether a bundle of land and services (no house) is one performance obligation may even depend on the location of the land. If the land could not be sold without the promise of services because the location is so remote, there might be one performance obligation. However, a different conclusion could be reached if the land is in a more developed area and the purchaser of a plot could separately arrange for the necessary amenities (e.g. roads, utilities, etc.). It might be more likely that there is only one performance obligation where the developer only sells fully developed plots with a house. This is because the customer is simply contracting for a completed house in a certain setting. Judgement is likely to be required to determine when goods and services are distinct in the context of a contract.
**Determine the transaction price**

The transaction price (or contract revenue) is the consideration the seller expects to be entitled to in exchange for satisfying its performance obligations.

Management must determine the amount of the transaction price at contract inception and reassess at each reporting date. This assessment may be complex where a contract includes variable consideration, a significant financing component (time value of money), non-cash consideration or consideration payable to the customer.

Variable consideration for entities in the real estate industry may come in the form of claims, awards and incentive payments, discounts, rebates, refunds, credits, price concessions, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity’s entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event.

Non-cash consideration is rare in practice but, as in IAS 18, the new standard requires that it be recorded at fair value. The new standard also requires that consideration payable to customers is deducted from revenue unless the seller receives distinct goods or services from its customer.

More significant changes arise in connection with variable consideration and time value of money.

<table>
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<tr>
<th>New standard</th>
<th>Current IFRS</th>
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<tbody>
<tr>
<td><strong>Variable consideration:</strong></td>
<td>Revenue is measured at the fair value of the consideration received or receivable. Fair value is the amount for which an asset or liability could have been exchanged or settled between knowledgeable, willing parties in an arm’s length transaction.</td>
</tr>
<tr>
<td>Variable consideration (for example, claims) should be estimated and included in the transaction price to the extent that it is highly probable that there will be no significant subsequent reversal in the cumulative amount of revenue recognised. This requires judgement.</td>
<td>Trade discounts, volume rebates, time value of money and other incentives (such as cash settlement discounts) are taken into account in measuring the fair value of the consideration to be received.</td>
</tr>
<tr>
<td>Variable consideration should be estimated using the expected value approach (probability weighted average) or the most likely amount, whichever is more predictive in the circumstances. The approach used is not a policy choice, but management should use the approach that it expects will best predict the amount of consideration to which the entity will be entitled based on the terms of the contract and taking into account all reasonably available information.</td>
<td>IAS 18 is not explicit as to whether all elements of consideration must meet the revenue recognition criteria simultaneously in order for any portion of the revenue to be recognised. As a result, we believe that a policy choice can be made; both the contingent and non-contingent elements of consideration are considered separately when determining when revenue is recognised or the contract is assessed as a whole. Whichever policy choice is taken, the policy should be applied consistently and, where material, be disclosed as a key accounting policy.</td>
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The following indicators suggest that including an estimate of variable consideration in the transaction price could result in a significant reversal of cumulative revenue (and therefore, that no revenue should be recognised):
The guidance in IAS 11 on contingent consideration is centred upon whether the consideration is reliably measurable. The standard indicates that an entity is generally able to make reliable estimates once the contract terms have been defined and the entity has an effective system of internal control. Construction contracts with variable consideration are generally accounted for based on amount of consideration expected to be received.

Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included because it does not pass the highly probable threshold. Management’s estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration.

**Time value of money:**

Should the contract contain a significant financing component, the transaction price should reflect the time value of money.

An entity is not required to consider the time value of money if the period between payment and the transfer of the promised goods or services is one year or less, as a practical expedient.

Revenue is discounted when the inflow of cash or cash equivalents is deferred. Interest is calculated and recognised using the effective interest method as set out in IAS 39. In practice, entities do not generally impute interest when cash is received in advance of performance.

In assessing whether a contract contains a significant financing component, an entity should consider various factors, including:

- the length of time between when the entity transfers the goods or services to the customer and when the customer pays for them;
- whether the amount of consideration would substantially differ if the customer paid cash when the goods or services were transferred; and the interest rate in the contract and prevailing interest rates in the relevant market.

For construction contracts in the scope of IAS 11, revenue should be recorded at fair value, which should take into account the effect of discounting, should it be material.
Potential impact:

**Real estate management:**
Under current guidance, performance fees that are tied to returns subject to performance targets may be recognised using one of two methods. Under the first approach, the manager recognises revenue based on the performance up to the measurement date, including an estimate of performance fees ultimately to be received. In this case, the manager’s estimates are reassessed at each measurement date. Under the second approach, non-contingent and contingent fees are analysed separately. Performance fees, being contingent amounts of revenue, are recognised as the services are performed but only when the fee becomes reliably measurable, which is often at the end of the performance period, once the outcome is known.

An example of this is entities that manage real estate investment funds with a finite life (for example, ten years) may receive performance fees that are subject to claw-back on a cumulative basis, based on the performance of the fund over its life. Distributions to the manager may have to be returned if the fund underperforms in the future.

Application of the new guidance may result in significant changes for entities that record revenue under the first approach given that the new standard requires a higher degree of certainty regarding the amount of the performance fee before revenue is recognised. On the other hand, those applying the second approach will need to consider whether a minimum amount of consideration should be recognised at an earlier point in time.

Managers of funds with a finite life will need to evaluate when performance fees (or a portion thereof) are no longer constrained by the variable consideration guidance and can be included in the transaction price. This may be at the end of the life of the fund, but it is possible that this may occur before the end of the fund’s life. An example of this may be that if a fund were to assess performance fees in relation to a high watermark, there may be a point in time in the later years of a fund’s life cycle where the fee is no longer constrained, given the fund’s cumulative performance in relation to remaining assets. This might be the point at which a fund that holds a limited number of remaining investments could sustain total losses on those investments and still exceed the high watermark. Therefore, a portion of the performance fee may no longer be constrained and should be recognised as revenue.

**Real estate developers:**
Real estate developers may enter into contracts where the consideration varies as a result of, for example, contingent consideration, discounts, price concessions, incentives, performance bonuses or other similar items. The new standard requires the developer to estimate the amount of consideration it expects to be entitled to taking into account the terms which may give rise to variability. This is estimated at contract inception and reassessed over the life of the contract.

Developers who defer recognising consideration under current guidance until such time as the variability is resolved (for example, uncertainty around contingent consideration clarified, or performance bonus determined) might be significantly affected by the new standard. Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if a portion of estimate of variable consideration is not included because it does not pass the highly probable threshold.

Management will also need to evaluate arrangements with customers to determine whether they include a significant financing component. It could be challenging for property developers to determine whether a significant financing component exists, especially when goods or services are delivered and cash payments received throughout the arrangement. The standard allows for some level of judgement by requiring entities to assess whether the substance of the arrangement contains a financing component.
Example – Variable consideration: Performance fees

Facts: A real estate fund manager has a management contract with a fund to provide investment management services for three years. In addition to a base management fee, the manager is entitled to a performance fee that is equal to 20% of profits generated by the investments in the fund when it achieves a return of over 8% per annum. The management agreement states that the performance fee shall be calculated, and paid, on the last business day of the third calendar year.

How should the manager account for the performance fee?

Discussion: The contractual measurement period is based on the terms of the contract, which in this case is three years. In determining whether to include an amount of variable consideration in the transaction price at the end of the financial period X1, the manager must assess whether it is highly probable that the amount included will not result in a significant reversal of revenue in future periods (the ‘constraint’). In other words, it is not an ‘all or nothing assessment’ and entities must always record the highest amount that is highly probable not to result in a significant future revenue reversal. This determination will require judgement, and to the extent that the variable consideration constraint is not met until the end of the year when the performance fee is known, the entire performance fee will only be recognised on the last day of the third calendar year. Applying the guidance in the new standard will often result in delayed revenue recognition as compared to current practice under the first approach in current IFRS discussed above.

How would this assessment change if the performance fee were subject to a 50% claw-back should the overall average performance achieved for a 5 year period (the three-year period covered by the contract, and the subsequent two-year period) not exceed 5%.

Discussion: The manager would need to factor into the determination of variable consideration the probability that the fund will outperform by 5% over the five-year period. This determination will require judgement, and to the extent that the variable consideration constraint is not met until the end of the fifth year, when the overall performance is known, the performance fee will only be recognised on the last day of the five-year period. To the extent that the revenue has not been recognised and cash has been received, the manager may need to recognise these amounts as an unearned revenue liability (that is, a contract liability).

Example – Time value of money

Facts: A contractor enters into a contract for the construction of a building on the customer’s land. This construction of the building is a single distinct performance obligation. Control passes to the customer over the contract term. The contract terms indicate specific dates on which the customer is required to make certain payments. These payments do not necessarily coincide with the performance by the contractor. The following milestones are established:

<table>
<thead>
<tr>
<th>Month of payment</th>
<th>Amount paid</th>
<th>Month in which the associated construction is performed</th>
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<tbody>
<tr>
<td>1</td>
<td>Cu 10 million</td>
<td>0 – 6</td>
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<tr>
<td>5</td>
<td>Cu 50 million</td>
<td>7 – 13</td>
</tr>
<tr>
<td>13</td>
<td>Cu 20 million</td>
<td>14 – 18</td>
</tr>
</tbody>
</table>

The contract is set up as such so that the contractor has the necessary funds to cover the cost of construction.
Discussion: The contractor charges the customer in advance. Management will need to consider the time period between payment and the completion of the related performance where the contractor is performing over time rather than at a specific point in time to assess whether there is a significant financing component taking into account the 12-month practical expedient offered by the standard. For example, the contractor may receive payment in month 5 but would perform over the period between month 7 to month 13, and thus there may not be a 12-month period between the date of payment and the associated performance. However, if there is a significant financing component, the contractor will need to assess whether a significant financing transaction exists. If a significant financing transaction does exist, the entity should calculate this finance component.
Recognise revenue when (or as) each performance obligation is satisfied

Cash receipts do not necessarily indicate that the entity is able to recognise revenue. Revenue is recognised under the new standard when a performance obligation is satisfied, which occurs when control of a good or service transfers to the customer. Control can transfer either at a point in time or over time based on a range of criteria. An entity should determine at contract inception whether control of a good or service is transferred over time or at a point in time.

An entity might begin activities on an anticipated contract prior to the arrangement meeting the criteria of IFRS 15 to be recognised as a contract with a customer. Revenue should be recognised on a cumulative catch-up basis if subsequent reassessment indicates the criteria are met. This cumulative catch up should reflect the performance obligation(s) that are partially satisfied, or satisfied on the contract reassessment date. An entity will need to determine the goods or services that the customer controls and, therefore, what portion of the costs are included in any measure of progress to determine the cumulative revenue recognised.

<table>
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<tr>
<td><strong>Recognise revenue over time or at a point in time:</strong></td>
<td>IFRIC 15, <em>Agreements for the construction of real estate</em>, provides guidance to assess whether a real estate development contract is in the scope of IAS 11 (a construction service) or IAS 18 (delivery of a good). Revenue for development units in the scope of IAS 18 is recognised when the risks and rewards of ownership of the units pass, which often coincides with the transfer of legal title or the passing of possession to the buyer. Revenue is recognised as the construction activity is completed for contracts within the scope of IAS 11. See further discussion below.</td>
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<tr>
<td>Real estate developers will need to consider whether they meet any of the three criteria necessary for recognition of revenue over time.</td>
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<td>A performance obligation is satisfied over time when at least one of the following criteria is met:</td>
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<td>• The customer receives and consumes the benefits of the entity’s performance as the entity performs.</td>
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<td>• The entity’s performance creates or enhances a customer-controlled asset.</td>
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<tr>
<td>• The asset being created has no alternative use to the entity, but the entity has a right to payment for performance completed to date.</td>
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<td>Without discussing all the indicators above, a common judgement in the real estate industry is whether the entity has the right to payment for performance completed to date. This is discussed in the example below.</td>
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<tr>
<td>A performance obligation is satisfied at a point in time if it does not meet the criteria above.</td>
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<tr>
<td>Determining when control transfers will require significant judgement. Indicators that might be considered in determining the point in time at</td>
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</table>
which control of the good or service (asset) passes to the customer include
but are not limited to:
- Whether the entity has a right to payment.
- Whether the customer has obtained legal title to the asset.
- Whether the entity has transferred possession of the asset to the
customer.
- Whether the customer has significant risks and rewards of ownership of
the asset.
- Whether the customer has accepted the asset.

**Measuring performance obligations satisfied over time:**

An entity should measure progress toward satisfaction of a performance
obligation that is satisfied over time using the method that best depicts the
transfer of goods or services to the customer. Methods for recognising
revenue when control transfers over time include:

- Output methods that recognise revenue on the basis of direct
measurement of the value to the customer of the entity’s performance to
date (for example, surveys of goods or services transferred to date,
contract milestones, appraisals of results achieved).
- Input methods that recognise revenue on the basis of the entity’s efforts
or inputs to the satisfaction of a performance obligation (for example,
cost-to-cost, labour hours, labour cost, machine hours, or material
quantities).

The method selected should be applied consistently to similar contracts with
customers. Once the metric is calculated to measure the extent to which
control has transferred, it must be applied to total contract revenue to
determine the amount of revenue to be recognised.

**Potential impact:**

**Real estate management:**

This assessment may not necessarily have a significant impact for the real estate management industry. This is because in most cases revenue will be
recognised over time for services provided. The pattern of revenue recognition is likely to be affected by how the entity estimates variable consideration (see
discussion above).

The timing of revenue recognition will need to be carefully considered where real estate managers receive upfront fees for a number performance
obligations, as discussed in the “Identification of performance obligations” section above.
**Real estate developers:**

Real estate developers will need to carefully consider the control transfer model to determine when and how to recognise revenue. Some entities that currently wait until completion of the contract to recognise revenue under IAS 18 will find that they should now recognise revenue as they construct the property under IFRS 15. This would be the case if the asset in question has no alternative use and the seller has a right to payment for performance to date. Typically, real estate that has been sold off-plan will meet the ‘no alternative use’ test because a specific unit may not be redirected contractually. However, any allowance in contract or statute that permits the customer to exit the contract without paying the full price may lead an entity to conclude that it does not have the right to payment.

In particular, entities should take care to evaluate the legal framework in which they operate because courts in some jurisdictions may not enforce contractual terms that require the customer to make full payment and receive the asset under construction. For example, courts in some countries may have an established practice of cancelling contracts and simply imposing a penalty should a customer selectively default on their obligation. The right to take back the asset and a penalty which is less than the full price of the contract does not constitute a right to payment for the developer.

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**Example – Right to payment**

**Facts:** A property developer signed sales and purchase agreements to sell specific apartments in an apartment block to different customers during the construction phase. Once the contract has been signed, the developer may not redirect the unit to another customer. All customers are required to pay a 10% non-refundable deposit, and pay the remainder of the transaction price based on milestones as determined in the contract. The performance does not create an asset with an alternative use.

If customer B defaults, the property developer will be entitled to 10% of the contract price and it can retain the work in progress completed to date. Any cash received above 10% will be refunded to the customer.

How should the developer recognise revenue from the sale of the apartment to customer B?

**Discussion:** Revenue is recognised over time if the apartment being constructed has no alternative use and the seller has a right to payment for the duration of the contract. Whilst this assessment will need to be made on a contract by contract basis, in this example the apartment will meet the ‘no alternative use’ test because the specific unit may not be redirected contractually.

The second criteria is that of a right to payment for performance to date. The entity must be entitled to an amount that at least compensates the entity for performance completed to date at all times throughout the duration of the contract if the contract is terminated by the customer or another party for reasons other than the entity’s failure to perform as promised. The right to receive a penalty and retain the work in progress (WIP) are not considered to provide the developer with a right to payment but are merely a payment of a deposit or a payment to compensate the entity for inconvenience of loss of profit. There is therefore no right to payment established in this contract. The entity should evaluate when control passes to the customer and recognise revenue on this date.
Example – Measure of progress towards complete satisfaction of performance obligation

Facts: A developer is constructing a high-rise apartment building. All units have been sold off-plan before construction commenced. The ground floor units are completed in Dec 20x1, however the top floor apartments are completed in June 20x2. There is a restriction on the purchasers from occupying the units until such time that the entire building is complete, and the safety inspection, which is required by the relevant regulations, has been performed.

Assume that there is only one performance obligation (the unit) and the criteria for recognising revenue over time have been met because the units have no alternate use, and the developer has a right to payment. How should the developer recognise revenue from the sale of the units?

Discussion: The developer has sold the individual units to individual customers. Each individual unit is a separate contract that includes a performance obligation that is satisfied over time. The developer would account for each contract separately; however, practically, the progress towards completion for each unit could be calculated by reference to the stage of completion of the apartment block as a whole.

The analysis would be different if the developer had not sold all the units off-plan before construction commenced. Revenue would not be recognised on unsold apartments, and costs associated with unsold apartments would be recorded as inventory.

This method would also not likely be appropriate if the developer was selling detached houses in a new estate, rather than apartments in a single building. This is because the completion of one house will not likely be dependent on the completion of another. Provided the criteria for revenue recognition criteria over time are met for the sale of each individual house, revenue would be measured based on the stage of completion assigned to each individual house rather than a single stage of completion being assigned to the development as a whole as in the case of an apartment block.

Example – Partial satisfaction of performance obligations

Facts: An entity begins constructing an apartment building and pre-sells 60% of the units. The asset has no alternate use, and the entity has a right to payment for work completed to date from the time at which the contract is signed. The remaining 40% of the units are constructed for inventory. At a later date, after the shell of the rooms of all floors of the apartment building has been completed, the entity enters into a new contract with a customer to sell one of the remaining units on the same terms as the original contracts. Thus, at inception of the new contract, a portion of the new customer’s unit is already completed.

Discussion: A cumulative catch-up adjustment is consistent with the principle of the standard of recognising revenue to depict an entity’s performance in transferring control of goods or services to the customer. Thus if activities performed prior to the contract establishment date have resulted in progress towards satisfying a performance obligation, the entity would recognise the revenue it expects to be entitled to for that progress completed to date.
**Contract costs**

The new standard provides specific guidance on the capitalisation of certain costs. An entity is required to recognise an asset for the incremental costs to obtain a contract that they expect to recover. In addition, an entity is required to capitalise costs it incurs to fulfil a contract if such costs relate to future performance and they are expected to be recovered.

Costs related to satisfied performance obligations and costs related to inefficiencies (that is, abnormal costs of materials, labour, or other costs to fulfil) are expensed as incurred.

<table>
<thead>
<tr>
<th>New standard</th>
<th>Current IFRS</th>
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<tbody>
<tr>
<td>An entity will recognise as an asset the incremental costs of obtaining a contract if it expects to recover those costs (for example, commissions). The incremental costs of obtaining a contract are those costs that the entity would not have incurred if the contract had not been obtained.</td>
<td>Fixed costs paid that are incremental and directly attributable to securing an investment contract (for example, sales commissions or placement fees) are capitalised if they can be identified separately, measured reliably, and it is probable that they will be recovered. An incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset is amortised in an appropriate manner.</td>
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<tr>
<td>Costs to fulfil its obligations under an existing contract, or an anticipated contract, are capitalised in accordance with IFRS 15 if no other accounting standard addresses such costs; for example, commissions paid for sales of units. Such costs are capitalised if the costs:</td>
<td>If the carrying value of the capitalised asset exceeds the recoverable amount, the asset is impaired and an impairment loss is recognised.</td>
</tr>
<tr>
<td>• relate directly to a specific contract (or anticipated contract);</td>
<td>IAS 11 contains guidance relating to contract costs. Costs that relate directly to a contract and are incurred in securing the contract are included as part of the contract costs if they can be separately identified, measured reliably, and it is probable that the contract will be obtained. Other detailed guidance on costs to fulfil a contract is also prescribed by current guidance.</td>
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<tr>
<td>• generate or enhance resources of the entity which will be used in satisfying, or continuing to satisfy future performance obligations; and</td>
<td></td>
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<tr>
<td>• are expected to be recovered.</td>
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<tr>
<td>An asset recognised in relation to contract costs is amortised on a systematic basis consistent with the pattern of transfer of the services to which the asset relates. This may include the transfer of goods or services to be provided under specific anticipated contracts (for example, a contract renewal). A practical expedient is available allowing such costs to be expensed when incurred if the amortisation period would be one year or less.</td>
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<tr>
<td>An impairment loss is recognised to the extent that the carrying amount of the capitalised asset exceeds the net amount of consideration to which the entity expects to be entitled in exchange for the services to which the asset relates, less the remaining costs that relate directly to providing those services.</td>
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</table>
Potential impact:

Existing construction contract guidance contains a substantial amount of guidance on cost capitalisation. The guidance in the new standard could result in a change in the measurement and recognition of contract costs as compared to today.

Lastly, existing construction contract guidance requires a loss to be recorded when the expected contract costs exceed the total anticipated contract revenue. Existing guidance related to the recognition of losses arising from contracts with customers will be retained for entities within the scope of that guidance.
Disclosures

The new standard includes a number of disclosure requirements intended to enable users of financial statements to understand the amount, timing and judgements around revenue recognition and corresponding cash flows arising from contracts with customers.

The more significant disclosure requirements are as follows:

• The disaggregation of revenue into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.
• An explanation of the significant changes in the contract asset and the contract liability balances during the reporting period.
• An analysis of the entity's remaining performance obligations including the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied), nature of the goods and services to be provided, timing of satisfaction and significant payment terms.
• Significant judgements and changes in judgements that affect the determination of the amount and timing of revenue from contracts with customers.
• Disclosure of the closing balances of capitalised costs to obtain and fulfil a contract and the amount of amortisation in the period.
Final thoughts

The above discussion does not address all aspects of the new standard. Companies should continue to evaluate how the new standard might change current business activities, including contract negotiations, key metrics (including debt covenants, surety, and prequalification capacity calculations), taxes, budgeting, controls and processes, information technology requirements, and accounting.

Entities will apply the new standard for reporting periods beginning on or after 1 January 2018; earlier adoption is permitted.

Entities can adopt the final standard retrospectively or use a simplified approach. Entities using the simplified approach will: (a) apply the new standard to all existing contracts as of the effective date and to contracts entered into subsequently; (b) recognise the cumulative effect of applying the new standard in the opening balance of retained earnings on the effective date; and (c) disclose, for existing and new contracts accounted for under the new standard, the impact of adopting the standard on all affected financial statement line items in the period the standard is adopted. An entity that uses this approach must disclose this fact in its financial statements.
About PwC’s Real Estate practice

PwC helps organisations and individuals create the value they’re looking for. We’re a network of firms in 157 countries with more than 184,000 people who are committed to delivering quality in assurance, tax and advisory services.

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PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams that have questions should contact members of the Revenue team in Accounting Consulting Services.

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