Capitalisation of costs associated with entering into contracts and complex aspects of revenue recognition: putting theory into practice (2/21/20)

International Financial Reporting Standard (IFRS) 15 *Revenue from Contracts with Customers* effective from 1 January 2018 adds to and combines the revenue recognition principles that were covered by several international standards earlier. Entities have run into a number of problems when applying IFRS 15. This article explores some of the issues addressed for more than a year by the International Financial Reporting Interpretations Committee ("IFRIC"), who explains to executives and accountants how IFRS should be applied in certain cases.

Revenue recognition principles

IFRS 15 replaces International Accounting Standard (IAS) 18 *Revenue* and IAS 11 *Construction Contracts*. IFRS 15 is mandatory for Latvian entities that prepare their financial statements to IFRS or whose parent requires that financial information be prepared to IFRS for group reporting purposes.

IFRS 15 lays down a uniform approach to recognising all revenue types and describes steps to be assessed in the process of revenue recognition:

> Step 1. Identifying a contract with a customer;
> Step 2. Separating out any contractual obligations to supply goods or services;
> Step 3. Measuring the total price of the contract or transaction after considering all discounts and variable charges;
> Step 4. Allocating the total transaction price to each separate obligation within the contract identified in Step 2;
> Step 5. The actual recognition of revenue in the new standard is based on control, leaving any risks and rewards of ownership as significant other indicators of control. Revenue is recognised over time or at a particular date, depending on the mechanism for transferring control.

These five steps of revenue recognition form the basis for all interpretations issued by IFRIC.

Costs associated with winning a contract

Under IFRS 15, all costs that are directly linked to winning a contract should be capitalised[1] and amortised over the period during which benefits will flow from the contract, so capitalisation is a must and not an option!

The capitalisation requirement applies only to costs that are directly and inseparably linked to winning the contract and which the company would not have incurred had the contract not been won. Examples of such costs include commission for winning the contract that is payable to a broker/agent/intermediary, a fee for attracting a customer that is payable to an intermediary, and bonuses payable to employees for each customer attracted additionally.

What this involves in practice is not only monitoring costs and capitalising those directly linked to winning the contract but also estimating how long the company will be receiving the benefits flowing from the contract.

Staff training on contract performance

Another issue addressed by IFRIC is concerned with staff training costs related to obtaining expertise required for contract performance. IFRIC finds that such training costs – just like costs associated with staff training on fixed assets or intangibles – cannot be capitalised because they are not directly linked to performing the particular contract (staff are acquiring knowledge they can use in performing other contracts in the future).

Capitalisation of other contract costs and construction contracts

Real estate ("RE") developers have approached IFRIC for an interpretation of the scope for capitalising costs incurred by third parties during the construction of RE intended for sale.

Before 2018, accounting for construction contracts was prescribed by IAS 11, which covers construction in particular, but now accounting for construction contracts is subject to the 5-step revenue recognition principle. In the case of developers, Step 5 is key – the transfer of control and whether revenue can be recognised only on the sale of RE or during the construction.

If revenue from construction is to be recognised over time, it must meet the criteria laid down by IFRS 15:

1. 1) The asset under construction is an improvement on another asset owned by the customer (e.g. a building being erected on the customer's land); or
2. 2) The asset under construction has no alternative use, and the builder is entitled under the contract to receive payment for the work done even if it is not completed.

Contracts that do not meet these criteria are accounted for under inventories, and no revenue is recognised until the asset is sold. However, contracts from which revenues are recognised over time have three possible accounting treatments:

1. If the RE has been sold to the customer and an invoice has been issued for the full value of all completed works, there is a receivable;
2. If the RE has been sold to the customer but no invoice has been issued or an invoice for the work done has been issued partly, there is a contract asset (or a receivable plus a contract asset); or
3. If the RE has not yet been sold but can be purchased at any time before completion and without restriction, then it is recognised under inventories.

In practice, questions are asked about which of the costs incurred during the contract are attributable to the contract and whether they can be recognised as part of the asset value (i.e. capitalised). IFRIC states that all costs directly linked to construction are part of the asset value and definitely represent either a receivable or a contract asset.

A different interpretation applies to borrowing costs linked to construction contracts where revenues are recognised over time. IFRIC prohibits interest charges from being capitalised as a receivable, contract asset, or inventory. This prohibition is made on the grounds that the selling price has been originally calculated by including anticipated interest charges, so it would not be correct to increase the asset by capitalising the loan costs again.

Prepayment for considering an application

The interpretations published by IFRIC over the year also deal with prepayment for considering an application to join an organisation. Although membership may be confirmed or denied, IFRIC's interpretation is made on the basis that the service rendered is membership of the organisation rather than considering an application, yet both actions are mutually inseparable.

Accordingly, the recipient of the prepayment cannot treat it as his revenue at the time of receipt, and no revenue should be recognised until the provision of service begins. If the service is denied without an obligation to refund the prepayment, this is recognised as revenue at the time of refusal.

Payments to the customer

Another topical issue is fees payable by contract or law to a customer for cancelling or delaying services, for example, a cancelled or delayed flight. In IFRIC interpretation, such fees are an integral part of the contract and should be considered when measuring the total price of the transaction in Step 3 of the revenue recognition process.

In practice, when revenue is recognised, any fees paid for cancelling or delaying services are deducted from it, as is now done with discounts or any other kinds of bonuses awarded to customers.

Revenue recognition is a complicated question, and more interpretations are expected on many other questions in the future. One thing to remember is that no revenue can be recognised if nothing has been transferred to the customer, and revenue should be recognised only to the extent expected to be received from the customer (ignoring recoverability).

[1] It should be recognised as an asset and amortised over time instead of being expensed immediately.