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A new global standard on revenue

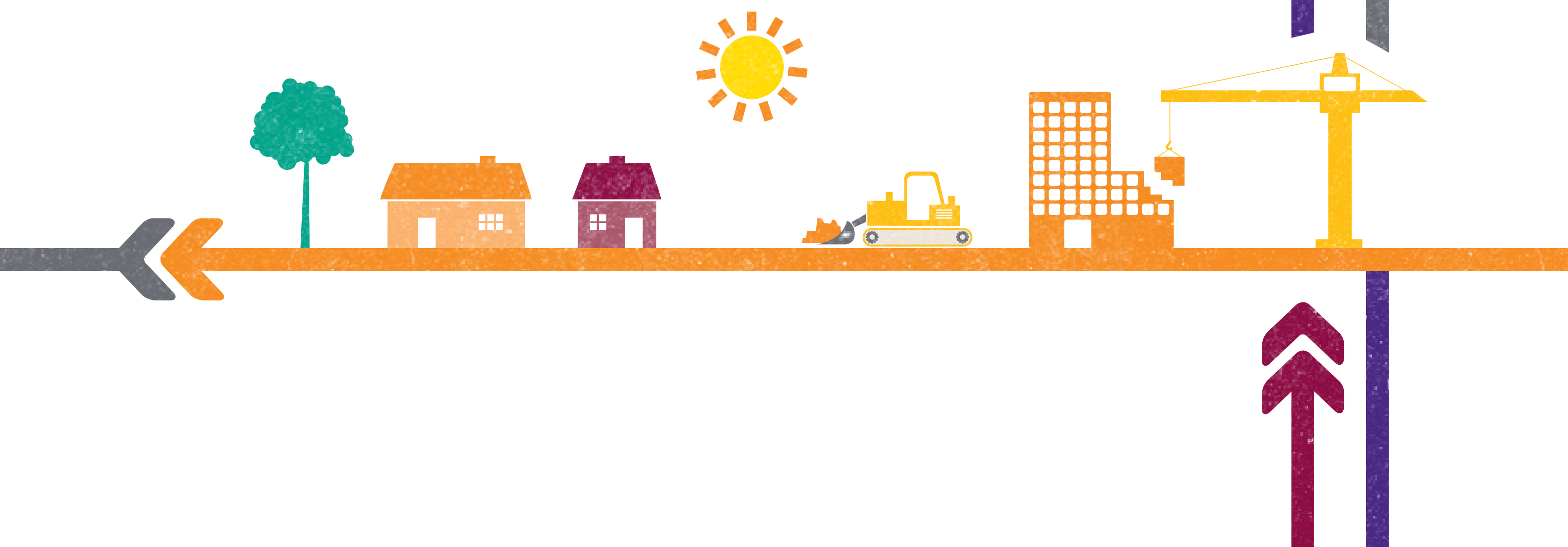
What this means for the construction industry

The International Accounting Standards Board (IASB) and U.S. FASB have finally issued their new Standard on revenue – IFRS 15 'Revenue from Contracts with Customers' (ASU 2014-09 or Topic 606 in the U.S.). This bulletin summarises the new requirements and what they will mean for the construction industry.

Recently issued IFRS 15 'Revenue from Contracts with Customers' replaces IAS 11 'Construction Contracts' and provides significant new guidance addressing key questions such as:

- Can revenue be recognised over time, or only upon completion?
- When do bundled services represent a separate performance obligation?
- What impact can contract modifications ('change orders') have on current and future revenues?
- When does entering into a second contract with the same customer impact revenue on the original contract?
- What costs should be included when estimating performance using the cost-to-cost method?
- How should incentive payments be accounted for?
- Can contract acquisition costs be capitalised, or must they be expensed?

With the potential to significantly impact the timing and amount of revenue recognised, construction entities will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.



The new Standard at a glance

The new Standard replaces IAS 11, IAS 18, and some revenue-related Interpretations. All transactions within its scope will apply a single, control-based model centred around the following 5-steps:

Step 1: Identify the contract with a customer

Step 2: Identify the performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations

Step 5: Recognise revenue when/as performance obligation(s) are satisfied

IFRS 15 changes the criteria for determining whether revenue is recognised at a point in time or over time. In addition, while the following points may vary in terms of their expected impact on the construction industry, IFRS 15 has more guidance in many areas where current IFRSs are lacking such as:

- multiple-element arrangements
- contract modifications
- non-cash and variable consideration
- rights of return and other customer options
- seller repurchase options and agreements
- warranties
- principal versus agent (gross versus net)
- licensing intellectual property
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements.

IFRS 15 will require considerably more disclosure about revenue recognition including information about contract balances and changes, remaining performance obligations (backlog), and key judgements around the timing of and methods for recognising revenue.

Transition and effective date

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Transition is retrospective, subject to some simplifications including an option not to restate comparative periods. Early application is permitted.

What this means for the construction industry

Accounting for revenue in the construction industry involves unique challenges, from dealing with how to account for frequent change orders and identifying costs incurred that are not representative of progress made towards completion, to determining whether a promised good or service is part of a larger performance obligation. While IAS 11 provides some detail on how to account for these kinds of arrangements, many more complex issues are not addressed and so many entities currently find themselves analogising to the FASB's ASC 605-35 for further guidance. As IAS 11 and most of ASC 605-35 (with the exception of determining the need for loss provisions) have now been superseded, entities will need to focus on analysing their arrangements under the new guidance in IFRS 15.

Step 1: Identify the contract with a customer

While IAS 11 applies to 'construction contracts', IFRS 15 applies more broadly.

While IAS 11 applies to 'construction contracts', IFRS 15 applies more broadly. With only limited exceptions, IFRS 15 applies to all contracts with customers to provide goods or services (eg sale of goods, provision of services, construction contracts, licensing arrangements, etc).

While broader in scope, IFRS 15 requires an arrangement to meet additional criteria before its detailed guidance can be applied, including:

- the contract has commercial substance
- the parties have approved the contract
- the entity can identify each party's rights and the payment terms
- it is probable the entity will collect the consideration.

Criteria not met

When payments are received from a customer before all of the above are met, these payments must be presented as a liability either until the criteria are met, or when one of the following occurs:

- performance is complete and all consideration received is non-refundable
- the arrangement has been cancelled and any consideration received is non-refundable.

Combining contracts

Current guidance within IAS 11 requires the exercise of considerable judgement when determining whether contracts should be combined, offering only a series of indicators that might indicate when two or more contracts form part of the same economic arrangement.

In contrast, IFRS 15 explicitly requires an entity to combine contracts that are entered into at or near the same time with the same customer if one or more of the following criteria are met:

- the contracts are negotiated as a package with a single commercial objective
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract
- the goods or services promised in the contracts are a single performance obligation.

The existence of explicit criteria to combine arrangements (and the fact that only one criterion must be met) may change the accounting outcome for some arrangements.

Contract modifications

Under IAS 11, changes to the scope and/or price of a contract are included in contract revenue when both:

- it is probable the customer will approve the variation and amount
- the amount of revenue can be reliably measured.

Under IFRS 15, if the parties have approved a change in the scope of a contract but have not yet reached agreement on the corresponding change in price, IFRS 15 requires an entity to estimate the change in the contract price by applying the concepts related to variable pricing and revenue constraint (discussed in Step 3).

Depending on the circumstances, a contract modification is accounted for either as a separate contract, as the termination of an existing contract and creation of a new contract, or as part of an existing contract. For example, where a fixed price contract is impacted by a subsequent change order that is not considered to be 'distinct' from the original performance obligation, then the seller adjusts both the transaction price and the measure of progress towards completion and adjusts revenue on a 'cumulative catch-up' basis.

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Step 2: Identify the performance obligations

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The cornerstone of the IFRS 15 model is the fact that revenue is recognised upon satisfaction of 'distinct' performance obligations rather than the contract as a whole. A promised good or service is 'distinct' if both:

- the customer benefits from the item on its own or along with other readily available resources
- it is 'seperately identifiable', eg the supplier does not provide a significant service integrating, modifying, or customising the various performance obligations.

A single construction contract could contain engineering, procurement and construction services that may be accounted for as separate performance obligations.

IFRS 15 clarifies that a single performance obligation exists when the entity provides a significant service of integrating a good or service with other goods or services in a contract to provide a combined output to the customer. As a result, many construction contracts will be accounted for as a single performance obligation. Significant judgement will be needed to evaluate the separability of multiple elements based on the 'distinct' criteria outlined above, and this may result in more or different elements being separated. For example, a single construction contract could contain engineering, procurement and construction services that may be accounted for as separate performance obligations.

Step 3: Determine the transaction price

Under IFRS 15, the 'transaction price' for a contract is "…the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer…". This consideration may include fixed or variable amounts or both.

Variable consideration

Variable pricing arrangements (eg awards or incentive payments) of one type or another are common in the construction industry. An entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach. The amount is further subject to a revenue constraint such that estimated amounts are included in the contract price only to the extent that it is highly probable that a subsequent change in the estimate will not result in a significant reversal of cumulative contract revenue recognised.

While significant judgement may be needed to assess many types of variable consideration under the new model, we do not expect these requirements to have a significant impact on incentive payments in particular as existing guidance requires incentive payments to be included in contract revenue when both:

- it is probable that the specified performance standards will be met or exceeded
- the amount of the incentive payment can be measured reliably.

Step 4: Allocate the transaction price to the performance obligations

> The extent to which an entity will be impacted by the new guidance will depend upon the accounting policy adopted under existing literature.

When an entity determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on relative stand-alone selling prices at contract inception.

Estimating stand-alone selling price

IFRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price. If not available (which we'd expect to be the case for many construction contracts), the entity estimates the stand-alone selling price using all available information, maximising the use of observable inputs. IFRS 15 suggests (but does not require) three possible methods:

- adjusted market assessment
- expected cost plus margin
- residual approach.

Currently, there is no specific guidance in IAS 11 for allocating revenue to multiple deliverables within a construction contract. Therefore, the extent to which an entity will be impacted by the new guidance will depend upon the accounting policy adopted under existing literature.

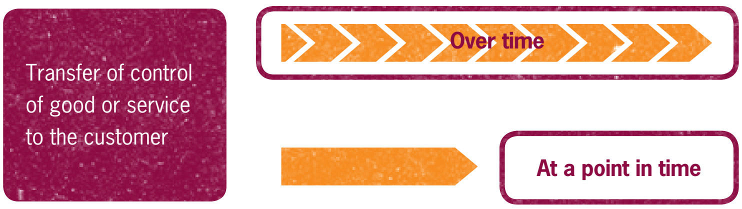
Step 5: Recognise revenue when/as performance obligations are satisfied

> While many construction-type contracts will transfer control of a good or service over time and therefore result in a similar pattern of revenue recognition compared to that determined under IAS 11, an entity cannot presume that there is no change in revenue timing and must carefully assess when control transfers to determine when to recognise revenue under IFRS 15.

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a point in time. Broadly, control is transferred *over time* if any one of the following conditions applies:

- the customer receives and consumes the benefits as the entity performs
- the customer controls the asset as it is created or enhanced
- the asset has no alternative use to the seller and the seller is entitled to payment for performance-to-date.

Transfer over time or at a point in time



If none of these conditions are satisfied, the entity recognises revenue at a *point in time*.

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For a performance obligation that is satisfied over time, an entity measures its progress towards completion in a way that depicts the pattern by which it transfers control of the goods/services to the customer. IFRS 15 discusses two classes of methods: input and output methods.

An entity must evaluate its existing methods to ensure they meet the objective under IFRS 15. For performance obligations satisfied over time, the cost-to-cost input method often applied today cannot be presumed to be the most appropriate measure of progress towards completion. Similarly, if the entity is essentially providing a procurement service related to materials for a project, to the extent that the materials are purchased and not installed, the entity adjusts the input method and only recognises revenue on such materials to the extent of the costs incurred. No margin is recognised until the materials are installed. This may result in an uneven profit margin over the life of the contract.

Other guidance

Contract costs

IFRS 15 requires an entity to capitalise the incremental costs of obtaining a contract if it expects to recover those costs. ‘Incremental costs’ of obtaining a contract are defined as costs that an entity would not have incurred if it had not obtained the contract (eg, some sales commissions). Costs that an entity incurs regardless of whether it obtains a contract (eg tendering costs) are expensed as incurred, unless the costs are explicitly chargeable to the customer regardless of whether the entity obtains the contract.

The new guidance will also lead businesses to reexamine their accounting policies with respect to contract mobilisation costs. While IAS 11 allows mobilisation costs to be capitalised and amortised over the life of the contract, many construction businesses tend to expense these costs as incurred. IFRS 15 requires such costs to be capitalised where specific criteria are met.

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Disclosures

All entities, especially those with contracts greater than one year in duration, will be required to provide additional disclosures beyond those currently required. As a result, systems and processes will need to capture and summarise the incremental information needed to comply with the new requirements.

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