ON THE
MARK

COLLINS BARROW

Share now

April 2017

Revenue recognition for construction contracts under IFRS 15

Craig Cross, CPA, CA, *is professional standards partner at Collins Barrow Toronto LLP. He provides guidance on the interpretation of accounting standards, supports engagement teams and oversees the development of training courses and tools.*

The timing of revenue recognition may need to change in the near term for a construction entity preparing IFRS financial statements. Specific accounting guidance on construction contracts contained in IAS 11 Construction Contracts is replaced effective for annual reporting periods beginning on or after January 1, 2018. The International Accounting Standards Board (IASB) has published a new standard, IFRS 15 Revenue from Contracts with Customers (IFRS 15). IFRS 15 sets out requirements for recognizing revenue that apply to all contracts with customers.

Overview

The core principle in IFRS 15 is that an entity should recognize revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To recognize revenue, a company would apply the following five steps:

1. Identify the contract(s) with the customer.
2. Identify the performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price.
5. Recognize revenue when a performance obligation is satisfied.

Application of these five steps may result in different accounting for construction contracts than is currently applied. Key steps where issues may arise in the application of IFRS 15 for construction companies are set out below.

Identifying performance obligations in contracts

An entity must evaluate the contractual terms and its customary business practices to identify whether there are distinct goods or services within each contract. Distinct goods or services are considered separate performance obligations and are accounted for separately. There are normally multiple components to a construction contract. The asset to be constructed and the services to be provided are likely to be highly dependent or integrated. This means that, in many instances, for accounting purposes, only one performance obligation exists in the contract. A detailed evaluation of each construction contract is required.

The transaction price

An entity considers the terms of the contract to determine the transaction price. The transaction price is 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 (for example, some sales taxes). The consideration promised in a construction contract frequently includes fixed amounts along with variable amounts. An entity includes variable consideration in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The total transaction price is then allocated to each performance obligation on the basis of the relative stand-alone selling price of each distinct good or service.

An independent member of
BAKER TILLY
INTERNATIONAL

Clarity Defined.
collinsbarrow.com

COLLINS BARROW

April 2017

Revenue recognition for construction contracts under IFRS 15

Recognizing revenue when a performance obligation is satisfied

Revenue is recognized upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. This can occur either at a point in time or over time. A performance obligation is satisfied over time, only if any of the following criteria are met:

- The customer receives and consumes the benefits of the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset (work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the customer does not have control over the asset created, but the entity has an enforceable right to payment for performance completed to date.

An entity has an enforceable right to payment only when it is entitled, at all times, to an amount that at least compensates the entity for performance to date if the contract is terminated for any reason other than non-performance.

Where an arrangement was within the scope of IAS 11, revenue and profits were recognized on a percentage of completion basis. Similar recognition under IFRS 15 is permitted, but only where enforceable contractual rights and obligations satisfy certain criteria. Since there is no automatic right to recognize revenue on a stage of completion basis, the timing of the recognition of construction revenue and profit may vary under the new standard.

Contract costs

Although guidance is not specific to construction contracts, IFRS 15 provides prescriptive guidance on pre-contract costs incurred and general guidance on contract costs or those incurred to fulfil a contract.

IFRS 15 requires incremental costs incurred in obtaining a contract with a customer to be recognized as an asset if an entity expects to recover the costs. A simplification of expensing exists where the amortization period is less than one year. The requirement for pre-contract costs to be incremental would generally prohibit most internal costs for a project – such as due diligence costs or wages for employees to prepare a proposal – from being capitalized, as those costs may have been incurred regardless of whether the contract was won or lost.

IAS 11 sets out how to account for expected contract losses, but no guidance is contained in IFRS 15. Therefore, an entity will need to now look to the more general guidance on onerous contracts contained in IAS 37 Provisions, Contingent Liabilities and Contingent Assets. This may impact timing for when these losses on construction contracts are recognized and/or measured.

In summary, accounting for revenue arising from a construction contract may result in accounting for revenue in a similar manner to current practice, through the stage of completion approach. However, a detailed read of the standard may raise questions on how the new recognition and measurement steps are to be applied to a contract. A thorough analysis of the nature of the contract entered into by the entity is critical on initial adoption, in order to establish IFRS 15 compliant accounting policies. Entities that are required to follow IFRS will need to document how they have complied with the requirements set out in IFRS 15 starting Q1 2018.

April 2017

Revenue recognition for construction contracts under IFRS 15

Any change in current practice could impact the availability of income for distributions, compliance with loan covenants and compensation and bonus plans calculations. Careful planning is critical. Contact your Collins Barrow advisor for assistance.

Craig Cross, CPA, CA, *is professional standards partner at Collins Barrow Toronto LLP. He provides guidance on the interpretation of accounting standards, supports engagement teams and oversees the development of training courses and tools.*

An independent member of BAKER TILLY INTERNATIONAL

Clarity Defined.
collinsbarrow.com

COLLINS BARROW

Collins Barrow periodically publishes *On The Mark* for its clients and associates. It is designed to highlight and summarize accounting, assurance and general business advice across Canada. While *On The Mark* may suggest general advice, we recommend professional advice always be sought before taking specific planning steps.