IFRS 15 and Construction
What does it mean for you?
The International Accounting Standards Board (IASB) published IFRS 15 Revenue from Contracts with Customers in May 2014 effective for reporting periods commencing on or after 1 January 2018. Since IFRS 15 replaces all of the existing guidance on revenue recognition, and applies to all entities and industries, there has been considerable confusion (and debate) as to what the likely impacts are going to be, across different industries, when adopted.

IFRS 15 replaces the accounting standard on Construction contracts (AASB 111/IAS 11) so there has been a particular focus on the potential impacts of the new standard on the property development and construction industry. This article highlights what the key implications of adopting IFRS 15 are expected to be for the property development and construction industry. It is vital that organisations understand and prepare now for the impact IFRS 15 will have on your business to avoid any unintended consequences such as breaching debt covenants or missing earnings targets.

Likely areas impacted upon by IFRS 15 include:

- Timing of revenue recognition
- The number of performance obligations that are contained within a contract
- Treatment of contract variations
- When should variable consideration associated with a contract be recognised
- Financing components within contracts
- Costs of obtaining a contract

1. Timing of revenue recognition

With the removal of the accounting standard on Construction contracts (AASB 111/IAS 11) the major concern of many construction and development companies was whether they could continue to use the % of completion method to record revenue on long term contracts. IFRS 15.35 outlines when an entity can use the % of completion method (referred to in IFRS 15 as recognising revenue over time). This method can be used if one of the following criteria is met:

a. the customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs (see paragraphs B3–B4);

b. the entity’s performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or

c. the entity’s performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

It is not always easy to interpret what each of the three criteria above actually mean! These criteria apply to all contracts with customers and not just those contracts in the construction industry so it’s important to provide context to them so that they can be clearly understood.

Paragraph (c) above is normally the relevant section with regards to construction contracts. In order to apply, both limbs must be met:

The first limb is nearly always met as the majority of construction contracts would not allow the builder an alternative use of the asset (i.e. the builder couldn’t sell the same building twice!) unless there is a situation where the client defaults under the contract (IFRS 15 doesn’t consider default in this judgement).

The second limb requires an enforceable right to payment for performance completed to date:

If they do have an enforceable right then revenue should be measured on a % of completion basis.

If not, then all revenue will be recognised at a point in time (usually once title passes).

Example:

Dev Co is a developer of residential apartment blocks. These are sold on the following basis:

- 5% deposit up-front
- Remainder once title passes
Dev Co does not have an enforceable right for payment for performance completed to date (i.e. no progress payments) and will recognise revenue at a point in time (once title passes).

2. The number of performance obligations that are contained within a contract

IFRS 15 requires all performance obligations contained in a contract to be identified, a portion of the transaction price allocated to each obligation, and revenue measured separately for each. In the context of construction contracts this become a critical element when applying IFRS 15. For instance, should house and land packages be separated into a) land and b) the construction phase? Are the design and construction phases different performance obligations?

To answer these questions a company must determine if the good or service that is promised to a customer is distinct. IFRS 15.27 states that a good or service is distinct if both of the following criteria are met:

a. 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 (i.e. the good or service is capable of being distinct); and

b. the entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the good or service is distinct within the context of the contract).

On the surface it would appear that there are many distinct goods or services provided within a construction contract, however this is not always the case. Integrating different parts of the contract is a critical element of any construction contract. IFRS 15.29 highlights this issue and outlines that a good or service is only distinct where the entity does not provide a significant service of integrating the good or service, whereby it uses that as an input to produce or deliver the combined output specified by the customer.

In essence, the majority of construction contracts will include a significant service of integrating the separate parts and therefore only contain one performance obligation.

Example (based on example 10 in IFRS 15 illustrative examples):

An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.

The promised goods and services are capable of being distinct in accordance with paragraph 27(a) of IFRS 15. That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.

However, the goods and services are not distinct within the context of the contract in accordance with paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15). That is, the entity’s promise to transfer individual goods and services in the contract are not separately identifiable from other promises in the contract. This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

The entity accounts for all of the goods and services in the contract as a single performance obligation.

3. Treatment of contract variations

Contract variations and modifications are common place in the construction industry. Revenue associated with variations can’t be recognised under IFRS 15 until it is approved by the parties to the contract. At first read, this requirement appears to imply a written agreement between the parties. However, IFRS 15.18 states that:

’A contract modification could be approved in writing, by oral agreement or implied by customary business practices’

As such, it will require judgement to determine when a contract variation is approved. Where approval has taken place but the corresponding change in price has not yet been agreed, then entities will need to follow the guidance on accounting for variable consideration outlined in section four below.

If the contract variation provides the client with additional ‘distinct’ goods or services (i.e. a new performance obligation) then the variation will be accounted for as a separate contract. In most cases however, the variation will not provide additional ‘distinct’ goods or services and be accounted for as an adjustment to the existing performance obligation(s). Where an entity is applying the % of completion method, forecast revenue and costs will need to be updated to include the impact of the variation and the new % of completion calculated. The resulting adjustment to revenue (new % of completion * adjusted total revenue
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– previously recorded revenue) will occur as at the date the variation is approved.

Example (based on example 9 in IFRS 15 illustrative examples):

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity’s access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity’s claim.

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 18–21 of IFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 21(b) of IFRS 15 by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 56–58 of IFRS 15 when estimating the transaction price.

4. When should variable consideration associated with a contract be recognised

Construction contracts often include variable elements such as contract variations and bonuses for meeting certain criteria or time constraints. IFRS 15 requires one of the following methods to be used to estimate this revenue (depending on which method better predicts the outcome):

- a probability weighted estimate; or
- the most likely amount.

Importantly though, IFRS 15 restricts how much of this type of revenue is actually recognised. Variable revenue (such as bonus payments) can only be recognised (IFRS15.56):

‘to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved’

In other words, the entity must be very confident they can predict the expected revenue with accuracy before it is permitted to be recognised. IFRS 15.57 highlights some possible examples which would bring into question an entity’s ability to meet the requirements of test above:

- the amount of consideration is highly susceptible to factors outside the entity’s influence (including weather conditions)
- the uncertainty about the amount of consideration is not expected to be resolved for a long period of time
- the entity’s experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value
- the contract has a large number and broad range of possible consideration amounts
- Where variable revenue hasn’t been recognised, the entity will assess at the end of each reporting period, whether the uncertainties that prevented recognition have been resolved, and recognise revenue at that point.

Example:

Dev Co enters into a contract with a customer which contains a $100,000 bonus if they finish the construction of a new factory within 24 months from signing of the contract. As this construction is in the tropics, Dev Co assesses their ability to finish the project within the timeframe will be highly susceptible to weather.

As the weather conditions over the next 24 months are not within the control of Dev Co they can not recognise the bonus until construction is complete (it is possible poor weather would cause a significant reversal in any revenue recognised).

5. Financing components within contracts

Sales in the property development and construction industry regularly include payments either up front or in arrears of, when revenue is recognised for accounting purposes. IFRS provides extensive guidance on the treatment of any financing component within a revenue contract (there is an exemption from this analysis if the time period between the payment and receipt of goods or services is less than one year). Where this component is deemed to be significant then it must be accounted for separately from revenue.
Example:

Dev Co has recently finished its latest high-rise apartment block on the Gold Coast. As 25% of the units remain unsold at the end of the development they have offered new purchasers of apartments the following terms:

- Purchase price $500,000
- 10% to be paid up front and the remainder to be paid in 2 years’ time
- Assume a discount rate of 6% per annum.

The arrangement contains a significant financing component (which extends beyond 1 year). The present value of the payments is calculated using the information above as $450,500. Which represents a financing component of $49,500 contained within the contract.

In this situation Dev Co recognises $450,500 as the revenue associated with the sale of the apartment on day 1 and interest revenue of $49,500 over the next 2 years.

6. Costs of obtaining a contract

IFRS 15 permits only the incremental costs of obtaining a contract to be capitalised. Costs that would have arisen regardless of whether the contract was obtained must be expensed when incurred.

Therefore, salary costs of employees and consulting fees (paid regardless of success) will need to be expensed under IFRS 15. Success fees paid to internal staff or external consultants when a new contract is secured should be capitalised.

Example:

Dev Co pays sales staff a monthly retainer and a 5% bonus for any sales made.

Under IFRS 15 Dev Co must expense the monthly retainer. The bonus will be capitalised as an asset as it is an incremental cost of obtaining a new contract.

The information contained in this article is for general guidance only and does not represent, nor intend to be, advice. We recommend that prior to taking any action or making any decision, that you consult with an advisor to ensure that individual circumstances are taken into account.

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1Costs that are explicitly chargeable to the customer regardless of whether the contract is obtained are recognised as assets.
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