

New on the Horizon: Revenue recognition for building and construction



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Revised revenue proposals are good news for building and construction companies

In November 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), together referred to as the Boards, published a revised joint exposure draft on revenue recognition ('Revised ED').

The original proposals released in June 2010 in the Exposure Draft *Revenue from Contracts with Customers* ('Original ED') received significant adverse comment, particularly from the building and construction ('B&C') sector, due to the primary concerns that the proposals may have resulted in:

- individual construction contracts having to be separated into multiple performance obligations, each of which would have required individual monitoring and accounting; and
- revenue and profits on construction contracts not being recognised until the customer obtained control of the asset, which might not have been until completion of the contract. The result would have been very lumpy profit recognition.

The B&C sector has expressed concerns over the original ED, and, judging by the Boards' revisions, these concerns have been heard. Both of these areas have been addressed in a positive manner for the sector.

On the multiple performance obligations issue, the Boards have clarified the proposal to identify separate performance obligations, resulting in the vast majority of construction contracts being accounted for as a single performance obligation. This is supported by explicit examples aimed at the B&C sector.

The Boards have also clarified and significantly broadened the criteria required to recognise revenue over time. Where an entity concludes that control of goods or services is transferred over time, it uses a suitable method of measuring progress. These include output methods (based on survey of works performed, milestone etc.) or input methods (such as cost incurred), and should result in a similar pattern of revenue recognition to the current *percentage of completion* accounting.

While the Boards have improved clarity and guidance in these areas, entities in the B&C sector will still need to assess whether each contract meets the necessary criteria; only in specific and probably limited circumstances would we still expect revenue recognition to be deferred until completion.

Unlike IAS 11, the revised ED does not include explicit guidance on accounting for construction contract variations and claims. Instead, it includes general guidance on contract modifications and other changes in the transaction price, which has been developed to apply to all industries. Judgement will therefore be required to apply this guidance in the B&C sector.

Attention in the B&C sector will start to turn towards the extensive disclosure requirements in respect of key judgements made in applying the revised ED. New internal processes may be required to collate the data required for these disclosures.

This newsletter is focused on the B&C sector. You may also want to read our more general publication on the revised ED *New on the Horizon: Revenue from contracts with customers*.

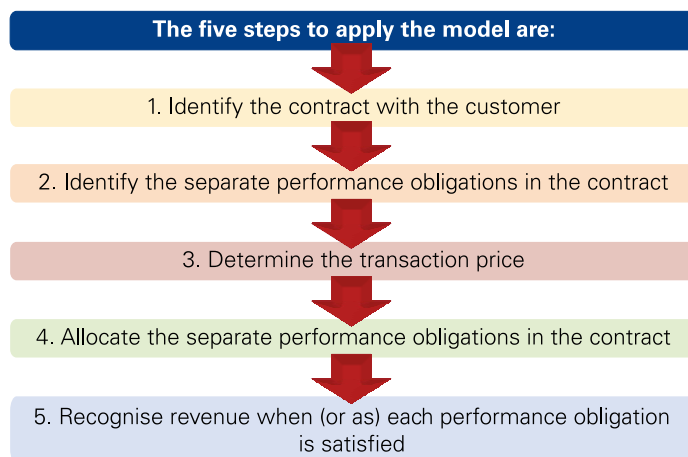
The five-step model for revenue recognition

The revised ED retains the five-step model for determining when to recognise revenue, based on the core principle that revenue is recognised when or as an entity transfers control of goods and services to customers.

Under the original ED, applying the model in the B&C sector raised two major concerns:

- the requirement to separate a single construction contract having a series of inter-related activities into multiple performance obligations and recognise revenue (and profit) as each performance obligation was satisfied; and
- the risk that revenue may only be recognised on customer acceptance of the project asset.

Under the revised ED, the identification of separable performance obligations and when control passes remain critical judgements which will need to be made at contract inception.



Critical judgements at contract inception

When to recognise an asset for costs of obtaining a contract?

The revised ED has amended the position previously taken by the Boards with respect to the cost of obtaining a contract. Under the revised proposals, an entity shall recognise as an asset the incremental costs of obtaining a contract with a customer if the entity *expects* to recover those costs. The incremental costs of obtaining a contract are defined as those costs that an entity would not have incurred if the contract had not been obtained.

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognised as an expense when incurred, unless those costs are fulfilment costs that meet the following criteria:

- relating directly to the contract;

- used in satisfying performance obligations; and
- expected to be recovered.

The costs of obtaining a contract are required to be presented separately from the net contract asset or liability on the face of the balance sheet.

KPMG observations

There is currently varied practice under IAS 11 as to when to capitalise bid costs. A common approach is to capitalise those costs incurred after the award of preferred bidder, to the extent that they are deemed recoverable under the contract. IAS 11 allows recognition once recovery is deemed *probable*.

The term 'expects to recover' is not defined within the revised ED and is new to IFRS. At this time, based on the wording in the revised ED we do not anticipate a change to current practice.

The definition of 'incremental costs of obtaining a contract' implies that only external costs could generally be recognised as an asset. Internal costs are less likely to meet the incremental costs tests and, for example, an allocation of bid team staff costs may be unlikely to meet the criteria to be recognised as an asset.

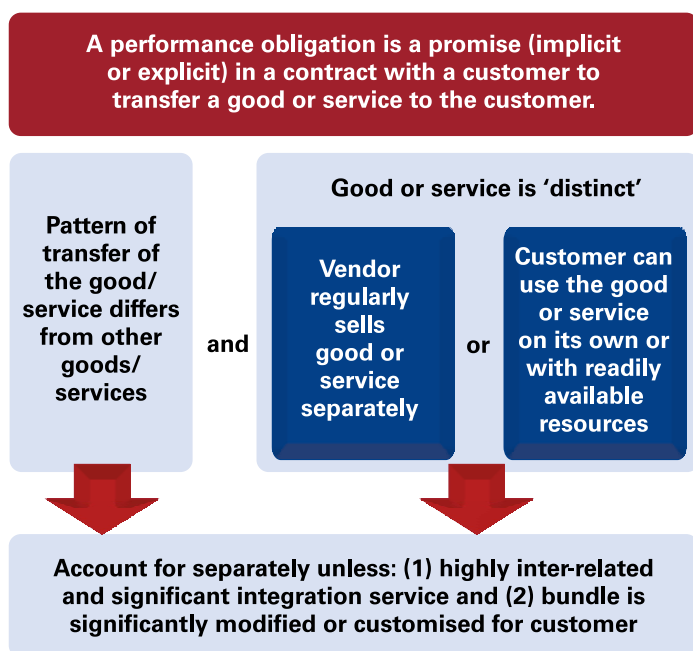
Typically, 'post-preferred bidder costs' comprise construction design costs as well as bidding expenses. Judgement will therefore be needed to determine whether costs incurred as part of contract negotiations represent costs of fulfilling the contract (included within a contract asset to the extent that it relates to unsatisfied performance obligations) or costs of obtaining a contract.

The revised ED represents a change from the original ED's proposed treatment to expense all costs incurred in obtaining a contract.

How many performance obligations in a contract?

In Step 2 of the five-step model, an entity is required to identify separate performance obligations in a contract. A performance obligation is a promise in a contract to transfer a good or service to the customer, and may be stated explicitly in the contract or may be implicit. Activities that an entity must undertake to fulfil a contract, but which do not transfer a good or service to the customer (e.g. administrative tasks), are not performance obligations.

Criteria for identifying separate performance obligations



An entity would account for a promised good or service as a separate performance obligation if it is distinct. However, if the pattern of transfer of control to the customer of distinct goods and services is the same, an entity may account for distinct goods and services as if they were one performance obligation.

KPMG observations

The B&C industry has expressed concern that the original ED required entities to analyse contracts to identify a large number of separate performance obligations. In an example provided in the original ED, the conclusion reached was that design, site preparation, site finishing and the remaining construction activities were distinct performance obligations.

It is significant that in an example in the revised ED relating to a construction contract fact pattern (see below) the 'design' and 'construction' contract contains only one performance obligation.

Entities will still need to exercise judgement and document their conclusion: namely that the distinct elements of the contract are highly inter-related, and that an integration service is performed to account for the contract as a single performance obligation.

Overall, this represents perhaps the most significant improvement in the revised ED for the B&C sector.

Example from the revised ED – Identification of performance obligations

"An entity enters into a contract to design and build a hospital. 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 entity would account for the bundle of goods and services as a single performance obligation ... because the goods or services in the bundle are highly inter-related and providing them to the customer requires the entity to also provide a significant service of integrating the goods or services into the combined item (i.e. the hospital) for which the customer has contracted. In addition, the goods or services are significantly modified and customised to fulfil the contract.

Revenue for the performance obligation would be recognised over time by selecting an appropriate measure of progress towards complete satisfaction of the performance obligation (assuming the criteria ... are met for satisfaction of a performance obligation over time)."

How to account for revenue: over time or at a point in time?

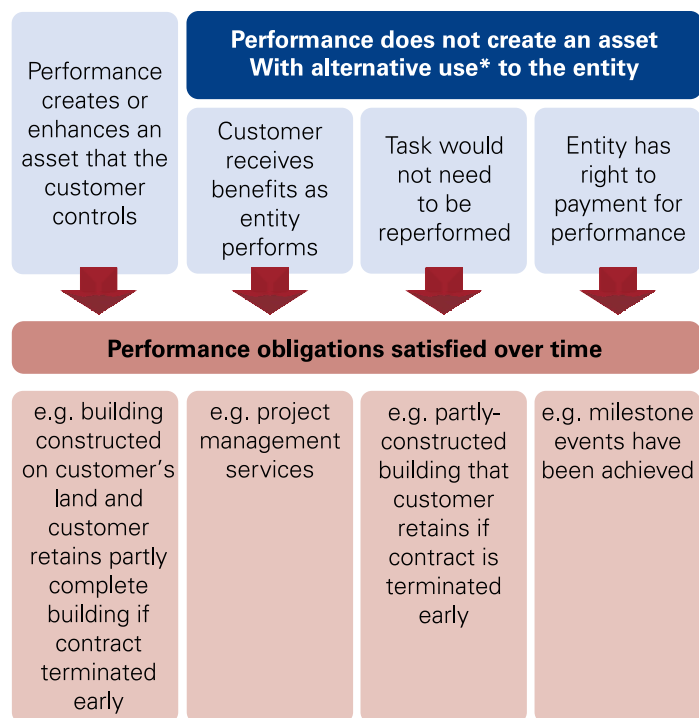
Step 5 of the revenue recognition model requires an entity to assess whether to recognise revenue over time or at a point in time.

Recognition of revenue over time

The second principal concern of the B&C sector arising from the original proposals was the risk to the ability of companies to continue to obtain a profile of revenue recognition similar to the stage of completion method under IAS 11 *Construction Contracts*.

The revised ED retains the core principle that revenue is recognised when or as performance obligations are satisfied through the transfer of control of a good or service to a customer. It now provides specific criteria upon which an entity is required to assess, at contract inception, whether it meets the criteria to recognise revenue over time.

Criteria for recognising revenue over time



* Alternative use exists if the entity has an ability to direct the asset to another customer

In assessing whether an asset has an alternative use to the entity, the revised ED states that a promised asset would not have an alternative use to an entity if the entity is unable, either contractually or practically, to readily direct the asset to another customer. Specifically, an asset would not have an alternative use if the contract had substantive terms that precluded the entity from directing the asset to another customer, or if the entity would incur significant costs (e.g. costs to rework the asset) to direct the asset to another customer.

KPMG observations

Many construction entities were concerned that the proposals in the original ED would have prohibited them from recognising revenue until contract completion if that work in progress were not controlled by the customer.

The new criteria suggest that more construction contracts will become subject to the transfer over time notion than would have been under the original ED.

However, while the transfer over time method is likely to be more accessible under the revised ED, for transactions currently accounted for using the stage of completion method – and other transactions involving the delivery of services and construction contracts – it will be necessary for management to evaluate contracts against the new criteria to establish whether it is appropriate to recognise revenue over time or at a point in time.

The assessment will require a detailed understanding of contract terms and, in the case of some real estate construction contracts, of local property law. This will become a key area of judgement in accounting for such contracts.

Application of the model to milestone construction contracts

Under certain contract arrangements, an entity may not be entitled to payment for works performed until specified performance milestones are met. In our view, where an entity receives payment for works performed only on achieving certain milestones, the continuous transfer method may still be appropriate for recognising revenue of works performed before reaching a specified milestone (prior to achieving a present right to payment).

For example, an entity has been contracted to construct a 100km road for a customer. The entity is paid based upon practical completion of each 10km section of road. The entity concludes that the transfer over time method is appropriate for more than one reason, for example that the entity's performance may enhance an asset which the customer controls.

Method of measuring progress

Where the customer obtains control of the goods or services in a performance obligation continuously, the revised exposure draft allows the entity to apply the revenue recognition method that best depicts the transfer of goods or services so as to recognise the amount of the performance obligation satisfied during each reporting period. Suitable methods to depict continuous transfer of goods or services include:

- output methods, i.e. methods based on units produced or delivered, milestones, surveys etc.;
- input methods that are based on efforts expended to date; and
- methods based on the passage of time, for instance for services transferred evenly over a period.

KPMG observations

It can therefore be seen that a method of revenue recognition akin to the IAS 11 percentage of completion method, including measurement based on the cost model, would be appropriate under the revised ED, *provided that the criteria for recognising revenue continuously over time, discussed above, are met.*

The selected method of measuring progress of a performance obligation may impact the profit recognition profile of a contract. Entities which apply the 'measure progress by reference to costs incurred to date as a proportion to total forecast cost' approach could have one consistent profit margin over the life of a contract, subject to claims, variations and other changes in circumstances.

Example – Assessing transfer of control

For example, on certain complex engineering contracts, the right to receive consideration may be constrained until it can be demonstrated that the asset meets the customer's specified technical requirements. A key judgement will therefore be the assessment of whether an entity can objectively assess whether customer acceptance is a formality. An entity's experience with contracts for construction of similar assets may provide evidence that the asset constructed for the customer is in accordance with the agreed specifications in the contract and that acceptance is therefore a formality.

It is likely that the more objective the acceptance criteria are the easier it will be for an entity to assert whether this indicator has been achieved. However, where an entity has entered into a contract to construct an asset with a highly complex commissioning phase, resulting in the entity not being able to objectively conclude that acceptance of the asset is a formality, revenue is likely to be recognised only when the customer accepts the asset. Therefore, the entity would not be able to demonstrate that it has created an asset that the customer controls.

Recognition of revenue at a point in time

There will be certain specific and probably limited circumstances where an entity is unable to demonstrate that it has met the criteria to recognise revenue over time. In such instances the entity will recognise revenue at the point when it satisfies the performance obligation by transferring control of the completed good or service to a customer.

The revised ED provides an indicator approach for determining when the customer has obtained control of a good or service (the asset).

Control may have been transferred to the customer if, for example:

- the entity has a present right to payment for the asset;
- the customer has legal title to the asset;
- the entity has transferred physical possession of the asset;
- the customer has the significant risks and rewards of ownership of the asset; or
- the customer has accepted the asset.

The Boards have amended the list of indicators from the original ED, with the removal of the 'design or function is customer specific' indicator and the inclusion of 'risks and rewards of ownership' and 'evidence of the customer's acceptance of the asset' indicators.

KPMG observations

There may remain limited circumstances where the commercial terms of a contract do not enable an entity to fulfil the 'performance does not create an asset with alternative use to the entity' criteria. In such instances the entity will need to assess whether its performance creates an asset which the customer controls, applying the above indicators.

The critical application of judgement will therefore be in assessing whether the transfer of control is constrained to a particular point in time.

In the B&C industry, the transfer of control may not be evidenced by all of the above indicators simultaneously. Judgement will therefore be required as to the various indicators' weight.

Critical judgements during contract life cycle

How to account for variations and claims under the contract?

Unlike IAS 11, the revised ED does not include explicit guidance on accounting for construction contract variations and claims. Instead, it includes general guidance on contract modifications and other changes in the transaction price (Step 3 of the model), which has been developed to apply to all industries. In this section, we consider the application of this general guidance to construction contracts.

Variations and claims under IAS 11

Companies in the B&C sector are accustomed to the definitions and specific recognition guidance within IAS 11.

	Definition	IAS 11 recognition criteria
Variation	<ul style="list-style-type: none"> • an instruction by the customer for a change in scope of the work to be performed under the contract. 	<ul style="list-style-type: none"> • probable that the customer will approve the variation and the amount of revenue arising from the variation; and • amount of revenue can be reliably measured.

	Definition	IAS 11 recognition criteria
Claim	<ul style="list-style-type: none"> an amount that the contractor seeks to collect from the customer as reimbursement for cost not included in the contract price. 	<ul style="list-style-type: none"> negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and the amount that it is probable will be accepted by the customer can be reliably measured.

The revised ED's general guidance on contract modifications is as follows.

Changes in the scope and price of a contract, e.g. variation orders

If there is a change to the scope and price of a construction contract, then an entity applies the following steps.

Firstly, the entity considers whether the change in scope is *approved* and the change in the price is *expected to be approved*. The entity does not recognise the variation order until both these tests are met. This appears to be a higher threshold than the IAS 11 requirement that it be probable that the customer will approve the variation order.

Secondly, the entity considers whether the variation order should be accounted for as a separate contract. We expect that the majority of variation orders will not be accounted for as separate contracts, as they are highly inter-related with the original contract. This is similar to current practice under IAS 11, under which variation orders typically do not meet the segmentation criteria which would require them to be treated as separate contracts.

Thirdly, the entity re-estimates both the total contract price and the stage of the completion of the contract. This may require the entity to adjust the cumulative revenue recognised to date. This adjustment may increase or decrease cumulative revenue recognised to date, depending on the circumstances¹.

Fourthly, the entity continues to account for the contract, by reference to the stage of completion as modified and the new contract price. Note that if the adjustment to the contract price is variable, then the entity applies the guidance on variable pricing discussed below.

¹ Note that a different approach would be required if the contract had been assessed as containing a number of separate performance obligations. However, as noted above, we expect that many construction contracts will be assessed to contain a single performance obligation, so the approach explained in this paragraph will apply.

Changes only to the price of the contract, e.g. claims

If there is a change only to the price of a construction contract, then the entity revises its estimate of the total contract price. The entity then allocates the revised transaction price according to the stage of completion of the contract. Once again, this may result in a cumulative adjustment to the amount of revenue recognised, subject to the constraints listed below.

Variable pricing

In practice, price changes arising from variations and claims may be uncertain. When this is the case, the entity must make additional judgements, in order to estimate the total contract price and determine the cumulative amount of revenue it is acceptable to recognise.

In order to estimate the total contract price when the contract price includes a variable amount of consideration, the entity uses one of the following methods to estimate the amount of consideration to which it expects to be entitled:

- the expected value – the sum of probability-weighted amounts in a range of possible consideration amounts; or
- the most likely amount – the single most likely outcome of the contract (which may be more appropriate if the transaction amount only has two possible outcomes, e.g. when there is a success fee that either will or will not be receivable).

The entity uses whichever of these amounts better predicts the amount of consideration to which it expects to be entitled.

Constraints to the amount of revenue recognised

In addition, the entity constrains the amount of revenue recognised, such that the cumulative amount of revenue recognised at any point in time does not exceed the amount that it is *reasonably assured to be entitled to receive*.

An entity is reasonably assured to be entitled to that amount only if *both* of the following criteria are met:

- the entity has experience with similar types of contracts (or has other persuasive evidence such as access to the experience of other entities with similar contracts); and
- the entity's experience is *predictive* of the outcome of the contract.

An entity's experience may not be predictive if, for example:

- the amount of consideration is highly susceptible to factors outside the influence of the entity (for example, the judgement of third parties);
- the uncertainty about the amount of consideration is not expected to be resolved for a long period of time;
- the entity's experience with similar types of contracts is limited; or
- the contract has a large number and high variability of possible consideration amounts.

KPMG observations

As a construction contract progresses, many of the key accounting judgements relate to the treatment of variations and claims. This can be the case particularly in the later stages of the contract, as the number of variations and claims accumulates. Often, the treatment of variations and claims becomes a key driver of contract margin.

The familiarity of the IAS 11 guidance can lead us to forget how limited it is, and how much judgement is required to apply it in practice. However, construction companies are accustomed to making these judgements, day-in day-out, on complex contract negotiations involving variations, claims and counter-claims.

In contrast, the revised ED asks construction companies to employ new judgements and estimates to account for variations and claims. As terms such as 'reasonably assured' are not defined in the ED, further evaluation of the Boards' intentions will be necessary as the standard setting process continues.

On a first read, the revised ED's requirement that a contract modification (e.g. a variation order) be *approved* before it is recognised appears higher than the current IAS 11 threshold that it is *probable* that the variation be approved. This reflects the general approach of the ED that an entity accounts for the enforceable rights and obligations arising under contracts.

However, if both the scope and price are changed, then the ED requires only that the change in price is *expected to be approved*. This is intended to accommodate unpriced change orders, which the ED notes are common in the industry.

When prices are variable, as will often be the case, an entity recognises revenue only to the extent that is *reasonably assured* that it will be entitled to that total amount. This is a new threshold and there is new guidance on how to apply it. A critical judgement in the recognition of variations and claims will be whether the entity's past experience can be considered predictive. Where an entity anticipates the claim being settled through adjudication or arbitration, the degree of uncertainty on the amount of consideration is likely to increase.

While many construction companies will welcome the ED's proposals on identification of performance obligations and completion over time, they should not neglect the detailed guidance on contract modifications and variable prices – a likely source of practice issues in applying the revised ED.

When are performance obligations considered onerous?

For performance obligations which are satisfied over a period of more than one year, the revised ED requires an entity to provide for loss making performance obligations. In the assessment of whether a performance obligation is onerous, the lower of direct costs of satisfying or the cost to exit the performance obligation is used.

The liability for an onerous performance obligation is reassessed at every reporting date.

KPMG observations

The onerous performance obligation test is performed using the transaction price determined for the contract and allocated to the performance obligations.

The onerous performance obligation test may result in a different threshold for inclusion of variable consideration than in current IAS 11 requirements. For example, under the revised ED, an estimate of entitlement to claim would be permitted for inclusion in the transaction price for the purpose of identifying and measuring onerous performance obligations, irrespective of whether negotiations with the customer were at an advanced stage.

What adjustments to make for customer credit risk?

The transaction price is not required to be adjusted for customer credit risk. Instead, an entity presents losses due to customer credit risk as an additional line in the profit or loss statement adjacent to the revenue line, as a deduction from revenue, both initially when the revenue is recognised and subsequently if changes in expected collections occur.

The deduction from revenue includes impairment losses on trade receivables and on contract assets.

Disclosures

The revised ED retains the additional disclosure requirements which were not included within IAS 11. These requirements are significant and the collection of the required information will be onerous for many entities.

Many of these disclosure requirements are narrative in nature. The revised ED refers to qualitative and quantitative disclosures, and we do not list the full requirements here. However, more significant disclosure items introduced include the following.

Disclosure requirement	KPMG observations
<p>An entity shall disclose information about its contracts with customers to help users understand the amount, timing and uncertainty of revenue and cash flows from contracts. This will include disaggregation of revenue (for example, by geography, market, contract type) to assist users in meeting the user objective.</p> <p>In addition, reconciliation between opening and closing contract balances will be required in respect of:</p> <ul style="list-style-type: none"> • contract assets and contract liabilities; • the liability recognised for onerous performance obligations; and • assets recognised from the costs incurred to obtain or fulfil a contract with a customer. 	<p>For contracting companies with a large number of projects this will be an onerous task. The requirement to separate out from contract balances those costs incurred but not yet installed in respect of a performance obligation will add further complexity to the preparation of the disclosure.</p>
<p>For contracts expected to be completed after one year from contract inception, the amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period and an explanation of when the entity expects to recognise that amount as revenue.</p>	<p>B&C entities will most likely need to prepare a separate reconciliation from the amount of remaining performance obligations to the total secured order book, which is typically disclosed in the narrative reporting. The secured order book disclosed is likely to exceed the amount of performance obligations remaining, as it will include amounts in respect of contracts which have yet to commence.</p>
<p>For onerous performance obligations, the amount of the liability recognised, along with a description of all of the following:</p> <ol style="list-style-type: none"> (a) the nature and amount of the remaining performance obligation(s) in the contract that are onerous for which the liability has been recognised; (b) why those performance obligations are onerous; and (c) when the entity expects to satisfy those performance obligations. 	<p>This disclosure enhances the granularity of onerous performance obligation reporting. The phasing of satisfaction of the liability may require entities to enhance contract reporting processes.</p>

Conclusions

While the overall structure of the ED proposals has not radically changed, the Boards have revised their position in respect of the application of the proposed standard to the construction sector. This will significantly change the implications for the majority of construction contracts.

For the most part, we expect construction contracts to be recognised as a single performance obligation, and to be able to fulfil the broad criteria for revenue recognition over time. Entities should consider commercial terms to ensure that access to revenue recognition over time is achievable, as failure to do so will lead to significant deferral of revenue and profit recognition. The lack of explicit guidance for the B&C sector on contract modifications and other changes in the transaction price will require judgement.

The ED is expected to be effective from periods commencing on or after 1 January 2015. Entities in the B&C sector should therefore look at their current processes and identify whether gaps exist in respect of the enhanced disclosure requirements, particularly in respect of the unwinding of remaining performance obligations and loss-making contracts.

The IASB has invited comments on the revised ED by 13 March 2012. KPMG will be analysing the revised ED in further detail over the coming months. We therefore invite contractors to contact us if they have any comments on the revised ED, so that we might consider these further in formulating KPMG's response to the IASB.

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