The new standard IFRS 15 on Revenue recognition

Construction, civil engineering and real estate development industries

Businesses in the construction, civil engineering and real estate development industries are about to face the implementation of a major standard incorporating the new principles of revenue recognition: IFRS 15.

This standard relies on the concept of transfer of control to recognise revenue, rather than on risks and rewards as previously. It requires a contract to be broken down into distinct performance obligations, each with their own margin and pattern of revenue recognition. Could IFRS 15 therefore call into question the recognition of revenue according to the stage of completion, or lead to a change in the pattern at which revenue and/or the margin is recognised?

MAZARS

What exactly is involved?

"IFRS 15 REPLACES IAS 18, IAS 11 AND ALL THE RELATED INTERPRETATIONS."

At the end of May 2014, the IASB published IFRS 15 on Revenue Recognition. Simultaneously, the FASB published ASU 2014-09 (Topic 606). These two broadly identical texts represent the culmination of work on a major joint project that has taken many years to complete.

IFRS 15 replaces IAS 18 on revenue arising from the sales of goods and the rendering of services, IAS 11 on construction contracts and all the related interpretations (IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31). This standard applies to all types of contracts with customers and all business sectors.

The core principle of IFRS 15 is that revenue shall be recognised so as to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Goods and services are regarded as having been transferred to the customer when the customer obtains control. This may take place at a point in time (for example when a good is delivered) or over time (for example as a service is rendered or a good is constructed).

IFRS 15 clarifies the accounting treatment of complex transactions (comprising several goods and/or services) and is generally more detailed than the standards it replaces.

Disclosures on contracts with customers will also be much more detailed than what is required today.

IFRS 15 will be mandatory for reporting periods beginning on or after 1st January 2017 (subject to endorsement by the European Union for European entities). Early application is permitted. An entity has the choice either of applying IFRS 15 retrospectively, or of applying an alternative method consisting in restating only the non-completed contracts at 1st January 2017.

A recognition model in 5 steps

> **IFRS 15 sets out a 5-step recognition model. The flowchart below presents these steps in simplified form.**

STEP 1 Identify the contract(s) with the customer

STEP 2 Identify the separate performance obligations (PO) in the contract

STEP 3 Determine the transaction price (TP)

STEP 4 Allocate the TP to the POs in the contract

STEP 5 Recognise the revenue when (or as) a PO is satisfied

Contract(s)

PO 1	PO 2
TP for contract	
TP allocated to PO 1	TP allocated to PO 2
Revenue on PO 1	Revenue on PO 2

This model is applicable to all contracts within the scope of the standard. IFRS 15 may, however, be applied to a portfolio of contracts, under certain conditions.

Step 1
Identify the contract(s) with the customer

"IFRS 15 ONLY ENVISAGES THE COMBINATION OF CONTRACTS IF THEY ARE CONCLUDED AT OR NEAR THE SAME TIME WITH THE SAME CUSTOMER (OR WITH RELATED PARTIES OF THE CUSTOMER)"

Combinations of contracts

In the construction, civil engineering and real estate development industries, some contracts are currently combined and accounted for as a single contract. The criteria for combination set out in IFRS 15 are unlikely to change existing practice in any significant way. Keep in mind, however, this is because IFRS 15 only envisages such combination for contracts concluded at or near the same time with the same customer (or with related parties of the customer).

Contract modifications

Contract modifications are common practice in the sector: additional works, amendments, changes to order specifications, orders for additional services, buyer modifications, etc.

The existing literature calls upon on entities to exercise their judgment in accounting for these contract modifications when calculating their revenue and margin.

The new standard provides a list of criteria for determining when a contract modification creates new enforceable rights and obligations for the parties. A contract modification may have three accounting consequences under IFRS 15:

- The continuation of the initial contract, and the treatment of the modification as a new and distinct contract
- The termination of the initial, partly satisfied contract and the prospective recognition of the unsatisfied part of the initial contract and of the modification together as a new contract
- The retrospective restatement (on a cumulative catch-up basis) of the amounts recognised under the initial contract, as if the modification had occurred at the start.

Entities will have to continue to exercise judgment, in particular in order to assess whether the modification relates to goods and services that are distinct from those provided under the initial contract (see step 2 below).

Step 2
Identify the separate performance obligations

The splitting of contracts into distinct performance obligations whenever a distinct good or service is promised to the customer is more clearly articulated by comparison with the existing standards. The identification of distinct performance obligations may be necessary under a variety of circumstances, whether in the construction, civil engineering or the real estate development industries: should the design, construction, maintenance, etc. be separated in practice? The same question applies to the land and the construction.

Warranties

In this sector, the majority of guarantees are insurance guarantees (for example, the ten-year warranties or completion guarantees required under French common law). A provision will continue to be accounted for in this respect. However, optional warranties or those offering an extra service (in addition to common practice and law), such as rent guarantees or resale price guarantees, may be regarded as distinct performance obligations. In this case therefore, a portion of the contract revenue shall be allocated to them.

Step 3
Determine the transaction price

Determining the contractual revenue to which an entity is entitled is necessarily more complex when the transaction price is variable.

Construction contracts may involve variable consideration in a number of ways: unit-price contracts, bonuses, claims, late penalties, etc.

IFRS 15 now provides detailed guidance of how these aspects are to be accounted for. In the first instance, variable consideration must be estimated using the 'expected value' or the 'most likely amount' methods. These estimates are recognised only to the extent that it is 'highly probable' that a significant reversal in the amount of cumulative revenue recognised will not occur. This constraint, as established by IFRS 15, is stricter than that set out in IAS 11. However, under some circumstances IFRS 15 may allow variable consideration to be recognised at an earlier stage.

The transaction price must also take into account any significant financing component to distinguish the price of the good or service from the financial element. In a sector based on long-term contracts, if the customer pays in advance (recognition of financial expenses) or in the event of deferred payment (recognition of financial income) the financial impact will have to be assessed.

"IN A SECTOR BASED ON LONG-TERM CONTRACTS, IF THE CUSTOMER PAYS IN ADVANCE OR IN THE EVENT OF DEFERRED PAYMENT THE FINANCIAL IMPACT WILL HAVE TO BE ASSESSED"

Step 4

Allocate the transaction price to each performance obligation

"ESTIMATING STAND-ALONE SELLING PRICES WILL THEREFORE REQUIRE CONSIDERABLE JUDGMENT."

The transaction price is then allocated to each performance obligation previously identified. **This allocation is usually made on a relative stand-alone selling price basis.**

If a stand-alone selling price of a distinct good or service is not directly observable, the entity must estimate it using the most appropriate method.

Estimating stand-alone selling prices will therefore require entities to exercise considerable judgment.

Another aspect for attention concerns the allocation of variable consideration, which may be allocated to a single performance obligation or to the contract as a whole.

Step 5

Recognise the revenue when (or as) a performance obligation is satisfied

IFRS 15 requires an entity to recognise revenue when the customer obtains control of the promised goods or services (i.e. over time or at a point in time).

The event triggering revenue recognition must be identified for each distinct performance obligation identified separately at step 2.

Within the same contract, some performance obligations may be satisfied over time (so the revenue is recognised as progress is made) while other performance obligations are satisfied at a point in time (meaning that revenue is recognised at a point in time).

Control is transferred to the customer over time if one of the following three criteria is met:

- the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g. construction on the customer's land);
- the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

Revenue recognition over time therefore always seems possible in some cases.

The impact of IFRS 15 must be assessed country by country, taking into account the local regulatory context.

IFRS 15 may cause revenue to be recognised over time (if transfer of control over time to the customer can be demonstrated) whereas, in the real estate development sector, it is recognised upon completion in some countries today.

In the case of a property development programme intended for several customers, revenue will only be recognised as work progresses for contracts that have already been signed.

Further, in the case where the progress is measured on the basis of costs incurred, the question arises for property developers whether to account for the land when measuring progress if the construction of the building has not yet begun.

What does IFRS 15 say about the following topics?

Costs of obtaining a contract

> According to IFRS 15, only the incremental costs of obtaining a contract (those which would not have been incurred if the contract had not been obtained) and which the entity expects to recover must be recognised as an asset, unless those costs are explicitly chargeable to the customer. This analysis differs from the existing treatment.

Costs to fulfil a contract

> IFRS 15 establishes a set of strict conditions to be fulfilled if an entity is to recognise costs incurred in fulfilling a contract as an asset (where they are not within the scope of another standard, for example, IAS 2 *Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets).*

> However, IFRS 15 does not state how costs to fulfil a contract should be allocated to the different performance obligations if these costs cannot be attributed directly to any particular performance obligation.

Recognition of the margin

> In addition to the pattern of revenue recognition, IFRS 15 may also have an impact on the pattern of recognition of the overall margin of the contract. Step 4 outlined above has a direct impact on the recognition of the overall margin of a contract, as it is mechanically allocated, in a potentially unequal manner to the different performance obligations in the contract.

> The pattern of revenue recognition can however differ from one performance obligation to another (see step 5).

> **Therefore, the straight-line recognition of the margin on a single contract may be called into question if a contract is identified as containing distinct performance obligations in step 2.**

Expected losses

> **Unlike IAS 11, IFRS 15 provides no guidance as to the recognition of expected losses.** In practice, an analysis under IAS 37 will need to be performed to identify onerous contracts. The analysis will be conducted on the contract as a whole, not on each performance obligation taken separately.

> IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs of a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and of any compensation or penalties arising from failure to fulfil it. It is therefore possible that the identification of onerous contracts and the assessment of expected losses will diverge from current practice.

A TEAM OF MAZARS PROFESSIONALS DEDICATED TO THE CONSTRUCTION, CIVIL ENGINEERING AND REAL ESTATE DEVELOPMENT INDUSTRIES

Multi-disciplinary professionals at your service...

Drawing on their knowledge of the issues at stake in your sector and your economic environment, our construction, civil engineering and real estate development professionals will support your projects in an integrated way to bring you tailor-made answers.

... to develop pragmatic solutions...

Mazars has acquired experience of the best market standards alongside numerous developers and players in the construction, civil engineering and real estate development sectors, enabling us to bring you practical solutions adapted to your needs.

... in a constantly-shifting economic and regulatory background

Our specialists' heavy involvement in the marketplace working groups ensures constantly updated skills and knowledge of the governance, tools used and financial packages regularly offered to businesses in your sector.

MAZARS IS AN INTERNATIONAL, INTEGRATED AND INDEPENDENT ORGANIZATION, SPECIALIZING IN AUDIT, ACCOUNTANCY, TAX, LEGAL AND ADVISORY SERVICES. AS OF JANUARY 1ST 2015, MAZARS AND ITS CORRESPONDENTS OPERATES THROUGHOUT 92 COUNTRIES. 73 OF THESE COUNTRIES ARE PART OF MAZARS INTEGRATED PARTNERSHIP AND 19 ARE MAZARS CORRESPONDENTS. THEY DRAW ON THE EXPERTISE OF OVER 15,000 PROFESSIONALS TO ASSIST MAJOR INTERNATIONAL GROUPS, SMES, PRIVATE INVESTORS AND PUBLIC BODIES AT EVERY STAGE OF THEIR DEVELOPMENT. THE PRAXITY ALLIANCE OFFERS MAZARS OPERATING CAPACITY VIA PROFESSIONAL TEAMS IN 18 ADDITIONAL COUNTRIES.

CONTACTS

GROUP REAL ESTATE PRACTICE
Shahab Moreh, CPA Partner
Tel: +1 212 375 6791
shahab.moreh@weisermazars.com

BELGIUM
Xavier Doyen, CPA Partner
Tel: +32 (0)2 779 02 02
xavier.doyen@mazars.be

CHINA
Julie Laulusa, Partner
Tel: +86 21 6168 1088
julie.laulusa@mazars.cn

Stephen Weatherseed, Partner
Tel: +852 2909 5699
stephen.weatherseed@mazars.hk

CZECH REPUBLIC
Milan Prokopius, Partner
Tel: +420 224 835 730
milan.prokopius@mazars.cz

DENMARK
Kurt Christensen, Partner
Tel: +45 35 26 52 22
kurt.christensen@mazars.dk

FRANCE
Olivier Thireau, Partner, head of the Construction division
Tel: +33 1 49 97 63 82
olivier.thireau@mazars.fr

Edouard Fossat, Partner, Doctrine
Tel: +33 1 49 97 65 92
edouard.fossat@mazars.fr

GERMANY
Stefan Kirchmann, Partner, Certified Tax Advisor
Tel: +49 69 96765 1203
stefan.kirchmann@mazars.de

INDIA
Viraf Mehta, Director
Tel: +91 22 6158 7200
viraf.mehta@mazars.in

Bharat Dhawan, Partner
Tel: +91 (124) 481 4444
bharat.dhawan@mazars.co.in

IRELAND
Mark Kennedy, Partner
Tel: +353 1 449 4442
mkennedy@mazars.ie

ITALY
Olivier Rombaut, Partner
Tel: +39 02 58 20 10
olivier.rombaut@mazars.it

JAPAN
Emmanuel Thierry, Partner
Tel: +81 (0)3 4500 6497
emmanuel.thierry@mazars.jp

LEBANON
Jacques Saade, Partner
Tel: +961 4 52 42 18
jacques.saade@mazars.com.lb

LUXEMBOURG
Pierre Friderich, Partner
Tel: +352 27 114-301
pierre.friderich@mazars.lu

MOROCCO
Kamal Mokdad, Partner
Tel: +212 5 22 423 425
kamal.mokdad@mazars.ma

NETHERLANDS
Carel Van Oldenbeek, Director
Tel: +31 88 277 24 67
carel.vanoldenbeek@mazars.nl

NORWAY
Jan Olaf Poulsen, Partner
Tel: +47 23 19 63 00
poulsen@mazars.no

POLAND
Olivier Degand, Partner
Tel: +48 22 25 55 272
o.degand@mazars.pl

PORTUGAL
Fernando Vieira, Partner
Tel: +351 217 210 183
fernandovieira@mazars.pt

ROMANIA
René Schöb, Partner
Tel: +40 21 528 5757
rene.schoeb@mazars.ro

SPAIN
Carlos Marcos, Partner
Tel: +34 915 624 030
carlos.marcos@mazars.es

SWEDEN
Åsa Andersson Eneberg, Partner
Tel: +46 707 33 35 82
asa.andersson@mazars.se

Tomas Ahlgren, Partner
Tel. +46 40 614 25 30
tomas.ahlgren@mazars.se

SWITZERLAND
Philippe Rubin, Partner
Tel: +41 21 310 49 02
philippe.rubin@mazars.ch

TUNISIA
Adel Mohsen Chaabaane, Partner
Tel: +216-71 964 898
adel.mohsenchaabane@mazars.com.tn

UNITED ARAB EMIRATES
Samir Bitar, Partner
Tel: +971 4 357 3730
sbitar@mazars.ae

UNITED KINGDOM
David Herbinet, Partner
Tel: +44 207 063 4419
david.herbinet@mazars.co.uk

UNITED STATES OF AMERICA
Shahab Moreh, CPA Partner
Tel: +1 212 375 6791
shahab.moreh@weisermazars.com

More information on www.mazars.com

Photos : © Thinkstock - Istock

Praxity MEMBER GLOBAL ALLIANCE OF INDEPENDENT FIRMS

M MAZARS