

New on the Horizon:

Revenue recognition for building and construction

July 2010

In June 2010 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published a joint exposure draft on revenue recognition, which will have significant implications on contract accounting in the building and construction (B&C) sector if implemented in its current form.

Exposure Draft ED/2010/6 *Revenue from Contracts with Customers* (the ED) is part of the Boards' ongoing project to develop a new, converged accounting standard on revenue recognition. It follows a discussion paper (DP) on this topic that was released in 2008.

There was widespread concern in the B&C sector that the DP's proposals would put an end to percentage of completion accounting, the methodology followed to recognise revenue on all construction contracts for assets specified by customers. The key concern was that the proposals would in effect require that revenue and profits from construction only be recognised once a contract was complete and the asset was accepted by the client. Such a result would lead to a very lumpy revenue and profit profile, which would not reflect the profile of work undertaken by an entity.

The ED confirms the IASB's intention to withdraw percentage of completion accounting. However, it appears that a broadly similar accounting outcome may be available under the ED's proposals for the majority of construction projects in which control of the building work-in-progress transfers to the customer as work is done. A significant amount of additional analysis may be required to assess whether that approach is appropriate and there would be at least some cases in which revenue recognition would be deferred.

This newsletter is focused on the B&C sector. You may also want to read our publication on the ED more generally [*New on the Horizon: Revenue from contracts with customers*](#).

KPMG's building and construction practice

KPMG serves a broad range of firms in the Engineering & Construction industry via an international network of member firms, ensuring that our diverse array of professionals can provide strategic insights and relevant guidance wherever our clients operate.



Overview of the requirements

The ED proposes that a revised standard on revenue recognition will replace both IAS 18 *Revenue* and IAS 11 *Construction Contracts* and also result in the withdrawal of IFRIC 15 *Agreements for the Construction of Real Estate*. The ED does not include the percentage of completion method for the recognition of revenue and profits, which would be removed from IFRSs with the withdrawal of IAS 11.

The ED introduces a five step model approach to accounting for revenue:

- 1 Identify the contract(s) with a customer.
- 2 Identify the separate performance obligations in the contract.
- 3 Determine the transaction price.
- 4 Allocate the transaction price to the separate performance obligations.
- 5 Recognise revenue when the entity satisfies each performance obligation.

Steps 2 and 5 are perhaps the most critical to the B&C sector.

Performance obligations

Under the ED, entities would be required to identify the separate performance obligations within contracts with customers, to the extent that the performance obligations are *distinct*. A performance obligation is defined in the ED as an enforceable promise in a contract with a customer to transfer a good or service to that customer. A performance obligation is considered to be *distinct* if the entity or another entity sells an identical or similar good or service separately; or because the entity could sell the good or service separately because it has a distinct function and a distinct profit margin. In addition, performance obligations do not need to be separated if they are satisfied at the same time.

Revenue is then recognised as those performance obligations are satisfied by transferring goods and services to the customer. The performance obligation is deemed to be satisfied when the customer *obtains control* of the promised good or service.

The key issue that arises from this concept in the B&C sector is determining when performance obligations should be accounted for separately. Example 11 in the ED illustrates how to apply this approach to a construction contract but will not answer every question. The example takes a construction project requiring design, procurement and construction activities. Among other things, it concludes that the design activity is a separate performance obligation because similar services are sold separately by the entity and by its competitors, and that site preparation and site finishing are separate performance obligations because they have distinct risks. Accordingly, those elements are accounted for separately. However, all other elements of the contract, including contract management and procurement, are treated as a single performance obligation and so are accounted together.

Example 11 is helpful in demonstrating how complex contracts could be addressed, but it should not be assumed that the same split will occur on all contracts. Each contract should be reviewed individually.

Identification of separate performance obligations

Set out below are two further examples of how an entity might approach the separation of performance obligations within a straightforward construction contract.

Single performance obligation	Separate performance obligations
<p>An entity enters into a contract to construct the shell and core of a building for a customer.</p> <p>The prime contractor subcontracts the component packages (piling, substructure, superstructure etc) and provides the construction management service to coordinate the works.</p> <p>This contract contains a single performance obligation. The provision of the construction management service covers the coordination of all subcontract packages necessary to fulfil the contractual obligations.</p>	<p>An entity enters into a contract to construct the shell and core and provide fit-out services for a customer.</p> <p>The prime contractor subcontracts the component packages (piling, substructure, superstructure, partition walls, ceiling etc) and provides the construction management service to coordinate the works.</p> <p>There is a separate market for the fit-out of buildings and therefore information is available to estimate the appropriate value associated to the separate shell and core and fit-out obligations.</p> <p>This contract contains two performance obligations: the shell and core construction services and the fit-out construction services.</p>

In practice, many contracts will not fit into either of these positions but will be somewhere in the middle. Questions that will arise and require detailed analysis include the following.

- Should site preparation be separated because demolition, clearance etc are not intrinsically linked to the construction, i.e. the demolition and site preparation could have been undertaken by a separate contractor?
- Should design works be separated? In many jurisdictions there may be a separate market for these services and they may commonly be sold separately. Alternatively, there may be elements that are inextricably linked to delivery.
- Should landscaping works be separated?
- Should the fit-out works be separated, or are they intrinsic to the project?
- Should variations be separated because their price is often negotiated independently? We discuss this important topic on page 7.



When an entity assesses that a contract contains separate performance obligations, practical challenges would arise in allocating the transaction price to separate performance obligations within the contract. In practice, the price of a contract that contains multiple performance obligations typically will be negotiated based on the overall project risk. In addition, certain preliminary costs will be borne across all performance obligations, and therefore an allocation methodology would need to be developed.

Satisfaction of performance obligations

The ED proposes that an entity recognise revenue when a performance obligation is satisfied, and that *each performance obligation would be satisfied when the customer obtains control of the goods or service*. The ED goes on to state that control passes when the customer has the ability to direct the use of the asset or the ability to receive the benefit from the asset.

This will give rise to a number of questions in the B&C sector and the answers will depend in many cases on the legal form of the contract and local property law. The key question will be whether the customer has control of the construction work-in-progress, i.e. the partially completed asset.

The ED includes a number of indicators that the customer has obtained control. These include:

- the customer has legal title
- the customer has physical possession
- the customer has the unconditional obligation to pay
- the design or function of the asset is customer specific.

In the case of many simple construction projects in which an entity constructs an asset on the customers' land, local property law dictates that the customer has title to the incomplete asset and the customer makes non-refundable progress payments, it is likely that an entity would be able to argue that the customer has both legal title and physical possession of the asset and so control has passed. However, this would again need to be considered on a contract-by-contract basis and a full understanding of the legal consequences of, among other things, termination of the contract would need to be assessed.



Continuous transfer

The ED states that there are cases in which control of the promised goods or services transfers to the customer on a continuous basis. It is through this mechanism that entities would be able to achieve accounting results similar to the percentage of completion method. If the customer obtains control of the goods or services continuously, then the entity would 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, based on efforts expended to date; and
- methods based on the passage of time, which would for instance be suitable for services transferred evenly over a period.

That is, a method of revenue recognition similar to the IAS 11 percentage of completion method could arise under the ED, *provided that continuous transfer of control of the work in progress occurs*.

Within the B&C sector, assessing whether transfer of control takes place on a continuous basis or at a point in time would be a critical accounting judgement, which would determine the profile of revenue recognition.

Set out below are the key indicators in the ED highlighted above, which can be used to determine whether control of the good or service provided has been transferred to the customer and certain considerations relevant to the sector.

Control indicator	KPMG comment
The customer has legal title	<p>Careful analysis would be needed in complex contractual arrangements, for example when the construction of a building is on a site not owned by the customer.</p> <p>Also, consideration would be needed as to which party to the contract retains ownership of any work-in-progress following termination of the contract. For instance, some contracts may include significant pre-fabrication elements; an analysis would need to be made as to who controls such work-in-progress.</p>





Control indicator	KPMG comment
The customer has an unconditional obligation to pay	<p>The key would be in the treatment of contract payments by the entity to the customer in the event that the constructed asset fails to meet customer's specifications on acceptance testing.</p> <p>It would be important to distinguish between contract penalties (being a deduction from the estimated contract price but not impacting progress payments to date) and the potential recovery of progress payments if the completed asset is not accepted by the customer.</p>
The customer has physical possession	<p>Within the B&C sector the customer may not legally obtain physical possession of the asset until the issuance of the certificate of practical completion (for either the asset as a whole or a section of the asset). However, if the asset is built on the customer's land, then the customer may through custom or land rights in effect have physical possession.</p>
The design or function is customer-specific	<p>In the majority of construction contracts the customer is able to alter the design of the asset prior to and during the course of construction.</p> <p>In certain circumstances, however, for example in the construction of military accommodation, the design is of a standardised nature.</p> <p>The majority of construction contracts allow for a degree of design creep and therefore consideration would be required of the extent to which the customer's ability to specify the design is substantive.</p>

Consideration also would be required of substantive customer acceptance clauses within the contract. Therefore, customer acceptance would also be considered in determining whether the customer has obtained control of the good or service. It would be important to assess whether customer sign-off is a formality or a more substantive element of contract completion.

The ED does not discuss the interaction between acceptance clauses and the assessment of whether control of the goods or services transfers to the customer on a continuous basis. This is an important area for B&C contracts, in which it is common for a periodic certification of work done to take place throughout the project with a final assessment of practical completion and acceptance of the asset.

In practice, the analysis of when control passes may be especially complex for some real estate development contracts, in which there is sometimes a significant time gap between the transfer of legal title and physical handover of the constructed property.

No single factor in isolation would determine whether the customer has obtained control of the good or service and each contract would need to be considered individually.

Other matters in the ED relevant to the sector

Below we consider certain other detailed issues relevant to the B&C sector and how these are affected by the ED.

Time value of money

An area that will provoke some debate in the sector is the topic of time value of money. The ED proposes that entities account separately for the financing element of advance payments, if material. Preparers will be familiar with the concept of discounting when cash is received after delivery and the impact of discounting is material. However, this is the first time in IFRSs that there would be an explicit requirement to consider the time value of money in respect of *advance* payments.

The ED proposes that an entity adjust the contract consideration when there is a material financing component. This could be an issue on many construction contracts in which cash is received in advance of contract performance. If this is the case, then entities would need to assess whether the amounts involved are material. Separate presentation of the financial component could be a significant issue given the low margins that most contracts generate.

Customer credit risk

There is a further complication that could affect the amount of the transaction price and therefore reported revenues. The ED proposes that the estimated amount of promised consideration be discounted to reflect the customer's credit risk. Once the right to receive the consideration becomes unconditional, the entity would recognise a receivable and present any subsequent gain arising on remeasurement of the receivable as other income and not as revenue.

Variations and claims

Companies in the B&C sector will be familiar with the specific guidance on the recognition of variations and claims contained within IAS 11. These can be recognised within the forecast contract value when negotiations have reached an advanced stage, such that it is probable that the customer will accept the claim and the amount can be measured reliably.





Unlike IAS 11, the ED includes no specific guidance on variations or claims as such. However, it does propose:

- guidance in respect of the recognition of contract modifications, being any change in contract price or scope initiated by the entity or the customer, which likely would be relevant in determining how to account for variations; and
- a general requirement for determining the transaction price of the contract, including the need to estimate the probability-weighted amount of consideration that an entity receives or expects to receive, which would be relevant in determining how to account for both variations, to the extent that the quantum is not agreed, and claims.

If a portion of the transaction price is variable, then the entity would include the variable component in the transaction price only if it can be “reasonably estimated”. If not, then the transaction price would be limited to amounts that can be reasonably estimated, e.g. fixed amounts. In order to assess whether a reasonable estimate of the variable consideration under the contract can be made, the following factors would be taken into account:

- whether the entity has experience with similar types of contract;
- the existence of factors that reduce the entity’s experience, e.g. susceptibility to external factors, long periods of uncertainty, degree of experience, variability in possible outcome; and
- the significance of changes in circumstances expected.

This approach differs from the clearly defined thresholds that are required under IAS 11 for the recognition of variations and claims. This gives rise to a concern that preparers could adopt a much wider interpretation of when claims and variations could be recognised than we have become used to under IAS 11 and, consequently, this could lead to a divergence of practice within the sector. However, although the language and thought processes may be different, we would not necessarily expect to see significant differences in the timing of recognition of these judgemental items.

Recognition of contract profit

Under IAS 11, contract revenue and expenses are recognised in accordance with the stage of completion of the contract, such that the contract margin typically is recognised over the period of the contract.

Under the ED, the allocation of revenue to specific performance obligations and the requirement to expense costs related to satisfied performance obligations may result in the irregular recognition of profits over the period of the contract. This would be particularly evident when a contract is assessed to contain separate performance obligations with different profit margins.

Onerous contracts

The ED proposes that a liability be recognised and a corresponding expense incurred if a performance obligation within a contract is onerous. This is a more focused approach than IAS 11 under which a loss provision is required when the contract as a whole is forecast to be loss making. Therefore, circumstances may arise under the ED whereby an onerous provision would be recognised on a separate performance obligation whilst the contract in its entirety is profitable. A disaggregated view of contract forecasts by separate performance obligation would therefore be required.

Contract costs

The ED specifies that the costs of fulfilling a contract can be recognised as an asset if the costs relate directly to a contract (or a specific contract under negotiation); and the costs relate to future performance obligations and are expected to be recovered.

General practice under IAS 11 is to capitalise bid costs incurred after the award of preferred bidder to the extent that they are deemed recoverable under the contract, from the point at which recovery is considered probable. The ED proposes that the costs of obtaining a contract (e.g. the costs of selling, marketing, advertising bid and proposal and negotiations) be expensed as incurred.

The proposal in the ED to expense bid costs therefore represents a significant change in treatment. However, a significant proportion of costs incurred during the post-preferred bidder stage typically relate to construction design and the planning of lifecycle and maintenance expenditure. Judgement would be needed to determine whether such costs incurred as part of the specific contract negotiation represent the costs of fulfilling the contract such that they should be capitalised. However, it would appear to be difficult to support the capitalisation of costs incurred before appointment as preferred bidder.

Presentation

The ED proposes that an entity present the net contract position in the statement of financial position as either a *contract asset* or a *contract liability* depending upon the relationship between the entity's and the customer's performance of obligations.

An unconditional right to receive consideration would be presented as a receivable and not as a contract asset.

When the entity has incurred costs in respect of materials that have not yet been installed and therefore no performance has been undertaken, the costs would be presented as inventory and not within the contract balances. This would therefore require additional disaggregated analysis of individual contract positions at the reporting date compared with the IAS 11 percentage of completion method.



Disclosure

The ED introduces a number of additional and detailed disclosure requirements that are not included in IAS 11. Many of these disclosure requirements are narrative (qualitative) in nature. The more significant additional disclosure proposals include the following:

Disclosure proposal	KPMG comment
An entity discloses information about its contracts with customers to help users understand the amount, timing and uncertainty of revenue and cash flows from contracts. This includes details of how revenue has been disaggregated and a reconciliation of opening and closing contract balances with revenue recognised and cash received during the period. It would also need to include a description of performance obligations.	For contracting companies with a large number of projects, this would be an onerous task. The proposal to separate out from contract balances those costs incurred but not yet installed in respect of performance obligations would add further complexity to the preparation of the disclosure.
For contracts with an original expected duration of more than one year, the entity discloses the amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period and the scheduling of related revenue recognition.	This disclosure is likely to be commercially sensitive, particularly for private companies, as it proposes disclosure of the phasing of secured order book at each reporting date.



Conclusions

While the ED may not lead to the widespread changes in contract accounting feared at the time of the DP, it will in all cases require a much more detailed level of analysis to be performed, on a contract-by-contract basis. This would likely require changes to underlying business processes to address:

- the identification of separate performance obligations;
- an analysis of the timing of transfer of control to the customer and whether continuous transfer is appropriate;
- the allocation of appropriate profit margins to identified performance obligations;
- the monitoring of forecast revenue and costs for each performance obligation; and
- the additional disclosure requirements.

Retrospective application of the standard is proposed, which would provide a significant challenge to contractors to assess each of their existing contracts in line with the accounting requirements. Such an exercise would need much cooperation from non-accounting operational personnel to assist in the assessment, identification and measurement processes necessary to implement the proposals.

The IASB has invited comments on the ED by 22 October 2010. KPMG will be analysing the ED in further detail over the coming months. We therefore invite contractors to contact us if they have any concerns with the ED, so that we might consider these in formulating KPMG's response to the IASB on the ED.



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