
IFRS 15 – REVENUE RECOGNITION TO CHANGE FOR THE CONSTRUCTION INDUSTRY

THIS MONTH WE TAKE A CLOSER LOOK AT THE IMPACTS ON THE CONSTRUCTION INDUSTRY OF IFRS 15 *REVENUE FROM CONTRACTS WITH CUSTOMERS*.

For entities in the construction industry, IFRS 15 can significantly change the pattern of revenue and profit recognition, as well as affect bank covenants, performance-based compensation (including bonuses and share-based payments), internal budgeting processes, and market and investor communications.

IFRS 15 contains more specific guidance on revenue recognition than the current AASB 18 *Revenue* standard.

The following areas within the construction industry are likely to be impacted under IFRS 15:

- Installing a specific piece of large equipment/machinery
- Mobilisation fees
- Performance penalties/bonuses
- Design and build contracts
- Contracts with significant payments in advance.

The effective date of IFRS 15 is for annual reporting periods beginning on or after 1 January 2017. The Australian Accounting Standards Board is expected to approve and release the Australian equivalent standard (AASB 15) by the end of this year.

Installing a specific piece of large equipment/machinery

While IFRS 15 allows revenue to be based on the proportion of costs incurred to date ('costs incurred to date' model), which is similar to the 'percentage of completion' method under AASB 111 *Construction Contracts*, it does potentially differ significantly in respect of the pattern of profit recognition when the construction contract involves the installation of large pieces of specific equipment or machinery (e.g. lifts, turbines, engines, etc.), which have a significant cost.

IFRS 15 requires that the cost of the equipment/machinery be excluded from the 'costs incurred to date' model when determining the profit recognised, because that cost is not indicative of the progress of the construction activity. When such material is installed and control passes, revenue is only recognised to the extent of the costs of the materials installed and no profit margin is recognised.

Under AASB 118, revenue and profit margin is typically recognised when the equipment is installed as part of the percentage of completion method.

In situations where large pieces of equipment are installed early on in the construction contract, IFRS 15 will most likely delay the recognition of revenue, and therefore profit, compared with current practice under AASB 111.

Mobilisation fees

Mobilisation fees, such as recruiting teams and building capacity to fulfil the contract are also excluded from the 'costs incurred to date' model. As the customer has not received a benefit from 'mobilisation', this does not represent revenue under IFRS 15. Any fees received from the customer associated with this mobilisation are not separately recognised as revenue, but are recognised as part of the total contract price and therefore recognised over the period of the contract.

Costs in relation to mobilisation activities may be capitalised and amortised over the period of the construction contract.

Performance penalties and bonuses

Penalty payments often apply when a project is not completed on time. Similarly, when a project is completed on time, or earlier than the agreed date, performance bonuses may also apply. Penalty payments and performance bonuses are variable consideration under IFRS 15.

Compared to AASB 118, IFRS 15 contains more detailed guidance on variable consideration. Under IFRS 15, variable consideration must be estimated using one of these two methods:

- Expected value method – this method involves adding up the probability-weighted amounts in the range of the total possible consideration, or
- Most likely value method – this method involves choosing the single most likely amount from a range of possibilities. This would be appropriate where there are say only two possible outcomes.

The method used should be the one that is expected to better predict the outcome. The estimate needs to be updated every reporting period.

When estimating variable consideration, IFRS 15 requires the application of 'constraint' and recognise variable consideration as revenue 'only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur'.

'Design and build' contracts

It is not uncommon to enter into separate contracts with a customer, one for design work, and the other for construction. IFRS 15 contains significantly more guidance when accounting for contracts that are not 'distinct' from another contract. 'Design and build' contracts are likely to be accounted for as one performance obligation under IFRS 15, rather than two separate contracts. This means that 'design' revenue will be recognised over the period of the 'design and build' performance obligation, rather than on completion of the 'design' contract.

Contracts with significant advance payment terms

Under IFRS 15, the amount of revenue recognised on construction contracts with significant advance payments terms is likely to be higher than the agreed contract price. The advanced payment from the customer represents a borrowing cost, which has effectively been netted off the amount received from the customer. Revenue recognised under IFRS 15 would effectively be 'grossed up' by the amount of interest expense (being the amount 'borrowed' from the customer to fund construction). It is likely that the borrowing cost would qualify for capitalisation if the asset under construction is a qualifying asset under AASB 123 *Borrowing Costs*.

Example 1

1 June 2018

- Builder Co enters into a contract to refurbish an old building and install a lift for \$5,000,000
- Refurbishment work is to be completed by 30 June 2019. If the refurbishment is not completed on time there will be a \$100,000 penalty for each week that Builder Co is late
- Builder Co estimates total costs for the project to be \$4,000,000
 - Lift cost: \$1,500,000
 - Other refurbishment costs, including installation costs of the lift ('refurbishment costs'): \$2,500,000.

Based on the facts above and details of progress below, how should Builder Co recognise revenue and profit at 30 June 2018, 31 December 2018, 30 June 2019, 31 December 2019 and 30 June 2020?

30 June 2018

- Only the lift is delivered.

Builder Co recognises revenue of \$1,500,000 and costs of \$1,500,000 when the lift is delivered on site. The cost of the lift is not indicative of the progress of Builder Co's refurbishment activity that it has promised to perform, so it does not recognise any profit when the lift is delivered.

	30 JUNE 2018
Revenue	\$1,500,000
Costs	\$1,500,000
Net profit	\$0

The contract contains penalty payment clauses which is a form of variable consideration. Builder Co would need to estimate the transaction price. Assume that Builder Co uses the expected value method and estimates the following probabilities:

ESTIMATED COMPLETION DATE	PROBABILITY	PROBABILITY-WEIGHTED CONSIDERATION
On time	50%	\$2,500,000 (\$5,000,000 X 50%)
One week late	30%	\$1,470,000 (\$4,900,000 X 30%)
Two weeks late	20%	\$960,000 (\$4,800,000 X 20%)
Transaction price		\$4,930,000

31 December 2018

- \$1,000,000 of the other \$2,500,000 refurbishment costs have been incurred.

Builder Co updates its estimates of the transaction price as follows:

ESTIMATED COMPLETION DATE	PROBABILITY	PROBABILITY-WEIGHTED CONSIDERATION
On time	60%	\$3,000,000 (\$5,000,000 X 60%)
One week late	30%	\$1,470,000 (\$4,900,000 X 30%)
Two weeks late	10%	\$480,000 (\$4,800,000 X 10%)
Transaction price		\$4,950,000

Refurbishment costs incurred to date is 40% (\$1,000,000 / \$2,500,000).

Transaction price allocated to the refurbishment is \$3,450,000 (\$4,950,000 - \$1,500,000)

Transaction price	\$4,950,000
Less: Price allocated to lift	(\$1,500,000)
Price allocated to refurbishment	\$3,450,000
% cost incurred to date	40%
Refurbishment revenue to date	\$1,380,000

	30 JUNE 2018	31 DECEMBER 2018	TOTAL TO DATE
Revenue	\$1,500,000	\$1,380,000	\$2,880,000
Costs	\$1,500,000	\$1,000,000	\$2,500,000
Net profit	\$0	\$380,000	\$380,000
Profit %	Nil	27.5%	13.2%



30 June 2019

- The owner of the building now wants Builder Co to make additional refurbishments to make the building more energy efficient
- Total contract price increased to \$7,000,000
- Total estimated costs increased to \$5,500,000, being:
 - Lift cost: \$1,500,000
 - Solar panels: \$1,000,000
 - Other refurbishment costs (including lift and solar panel installation): \$3,000,000
- Other refurbishment costs incurred to date is \$2,000,000
- The completion date is extended to 10 February 2020
- The same penalty will apply if refurbishment is not completed on time
- In addition, the owner wants to add a swimming pool and a landscaped garden. The price agreed for this particular piece of work is \$500,000.

The additional refurbishments to make the building more energy efficient are highly interrelated with the original refurbishments. The additional refurbishments are accounted for as a contract modification of the original contract.

The additional swimming pool and landscaped garden can be argued to be 'distinct' i.e. separate from the promise to refurbish the building. If \$500,000 is the stand alone selling price, then it is treated as a separate contract, and revenue is recognised separately. If \$500,000 is not the stand alone selling price (e.g. a discount is offered) then the additional swimming pool and landscaped garden also need to be included within the original contract as a contract modification. (For the purposes of the rest of this illustration, only the accounting for the modified refurbishment contract is considered. The accounting for the swimming pool and landscape which is considered to be a separate contract is not further illustrated.)

Builder Co updates its estimates the transaction price at 30 June 2019, taking into account the additional refurbishment required, its progress completed to date, and the fact that Builder Co has never performed the energy efficient related refurbishments before.

ESTIMATED COMPLETION DATE	PROBABILITY	PROBABILITY-WEIGHTED CONSIDERATION
On time	20%	\$1,400,000 (\$7,000,000 X 20%)
One week late	40%	\$2,760,000 (\$6,900,000 X 40%)
Two weeks late	40%	\$2,720,000 (\$6,800,000 X 40%)
Transaction price		\$6,880,000

Transaction price allocated to the refurbishment is \$4,380,000 (\$6,880,000 - \$2,500,000).

Refurbishment costs incurred to date is 66.67% (\$2,000,000/\$3,000,000).

Transaction price	\$6,880,000
Less: Price allocated to lift & solar panels	(\$2,500,000)
Price allocated to refurbishment	\$4,380,000
% cost incurred to date	66.67%
Revenue to date on refurbishment	\$2,920,000
Revenue recognised in prior periods on refurbishment	\$1,380,000
Refurbishment revenue for the period	\$1,540,000

	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	TOTAL TO DATE
Revenue	\$1,500,000	\$1,380,000	\$1,540,000	\$4,420,000
Costs	\$1,500,000	\$1,000,000	\$1,000,000	\$3,500,000
Net profit	\$0	\$380,000	\$540,000	\$920,000
Profit %	Nil	27.5%	35.1%	20.8%

31 December 2019

- Builder Co has completed all the major refurbishments other than the installation of the solar panels.

Builder Co estimates that there is a 100% probability that the refurbishment will be completed on time, so the estimated transaction price is \$7,000,000.

Transaction price	\$7,000,000
Less: Price allocated to lift & solar panels	(\$2,500,000)
Price allocated to refurbishment	\$4,500,000
% cost incurred to date	100%
Revenue to date on refurbishment	\$4,500,000
Revenue recognised in prior periods on refurbishment	\$2,920,000
Refurbishment revenue for the period	\$1,580,000



	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	TOTAL TO DATE
Revenue	\$1,500,000	\$1,380,000	\$1,540,000	\$1,580,000	\$6,000,000
Costs	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$4,500,000
Net profit	\$0	\$380,000	\$540,000	\$580,000	\$1,500,000
Profit %	Nil	27.5%	35.1%	36.7%	25%

10 February 2020

- The solar panels were delivered and installed
- The refurbishment project was completed on time and accepted by the owner.

Builder Co recognises revenue of \$1,000,000 and costs of \$1,000,000. The cost of the solar panels is not indicative of the progress of Builder Co's refurbishment activity that it has promised to perform so it does not recognise any profit on the solar panels.

	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
Revenue	\$1,500,000	\$1,380,000	\$1,540,000	\$1,580,000	\$1,000,000	\$7,000,000
Costs	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$5,500,000
Net profit	\$0	\$380,000	\$540,000	\$580,000	\$0	\$1,500,000
Profit %	Nil	27.5%	35.1%	36.7%	Nil	21.4%

Summary

The following two tables summarise the revenue and profit recognised for each of the reporting periods under AASB 118 *Revenue* and the new IFRS 15 standard. The results demonstrate how the pattern of revenue and profit recognition changes significantly under IFRS 15. Refer to Appendix A on page 7 for detailed calculations.

AASB 118 REVENUE	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
Revenue for the period	\$1,875,000	\$1,250,000	\$1,329,545	\$1,272,727	\$1,272,727	\$7,000,000
Costs for the period	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$5,500,000
Profit for the period	\$375,000	\$250,000	\$329,545	\$272,727	\$272,727	\$1,500,000
Profit %	20%	20%	24.8%	21.4%	21.4%	21.4%

IFRS 15 REVENUE	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
Total revenue for the period	\$1,500,000	\$1,380,000	\$1,540,000	\$1,580,000	\$1,000,000	\$7,000,000
Total costs for the period	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$5,500,000
Profit for the period	\$0	\$380,000	\$540,000	\$580,000	\$0	\$1,500,000
Profit %	Nil	27.5%	35.1%	36.7%	Nil	21.4%

Example 2

On 1 June 2018, Builder Co enters into a contract to refurbish an old building.

Builder Co charges the customer a mobilisation fee of \$200,000 to set up site security, and bring in equipment and facilities such as a port-a-cabin and a port-a-loo for the construction workers.

The mobilisation cost to Builder Co is \$150,000.

How should Builder Co recognise the mobilisation fee and the associated costs?

The customer has not received a benefit from 'mobilisation'. The \$200,000 received from the customer is therefore not recognised separately as revenue on 1 June 2018, but is included in the transaction price, and recognised as revenue over the period of the construction contract as Builder Co performs its performance obligation. The mobilisation costs are capitalised and amortised over the period of the construction contract. Under IFRS 15, this results in revenue and profit being deferred.



The journal entries under IFRS 15 are as follows:

	DR	CR
DR Contract asset	\$150,000	
CR Cash		\$150,000

	DR	CR
DR Cash	\$200,000	
CR Deferred revenue		\$200,000

It is not uncommon in practice under AASB 118 today to account for the mobilisation fee separately from the construction contract.

1 June 2018

Profit or loss

	AASB 118	IFRS 15
Revenue	\$200,000	-
Costs	\$150,000	-
Net profit	\$50,000	-

Balance sheet

	AASB 118	IFRS 15
Contract asset	-	\$150,000
Deferred revenue		\$200,000

Example 3

On 1 January 2018, Construction Co enters into two contracts, one to design, and the other to build, a factory.

	Fee	Cost
Design	\$1,000,000	\$500,000
Construction	\$2,000,000	\$1,500,000
Total	\$3,000,000	\$2,000,000

The design stage is completed by 30 June 2018 and the construction of the factory is completed by 30 June 2019.

How should Construction Co recognise revenue at 30 June 2018 and 2019?

Because the two elements of the contract are highly interrelated, the two elements are treated as one performance obligation. Assuming the project does not involve installing a specific piece of large equipment/machinery, under the 'costs incurred to date' model in IFRS 15, Construction Co would recognise 25% of the revenue (\$500,000/\$2,000,000) at 30 June 2018.

It is not uncommon in practice under AASB 118 today to account for the two elements separately.

30 June 2018

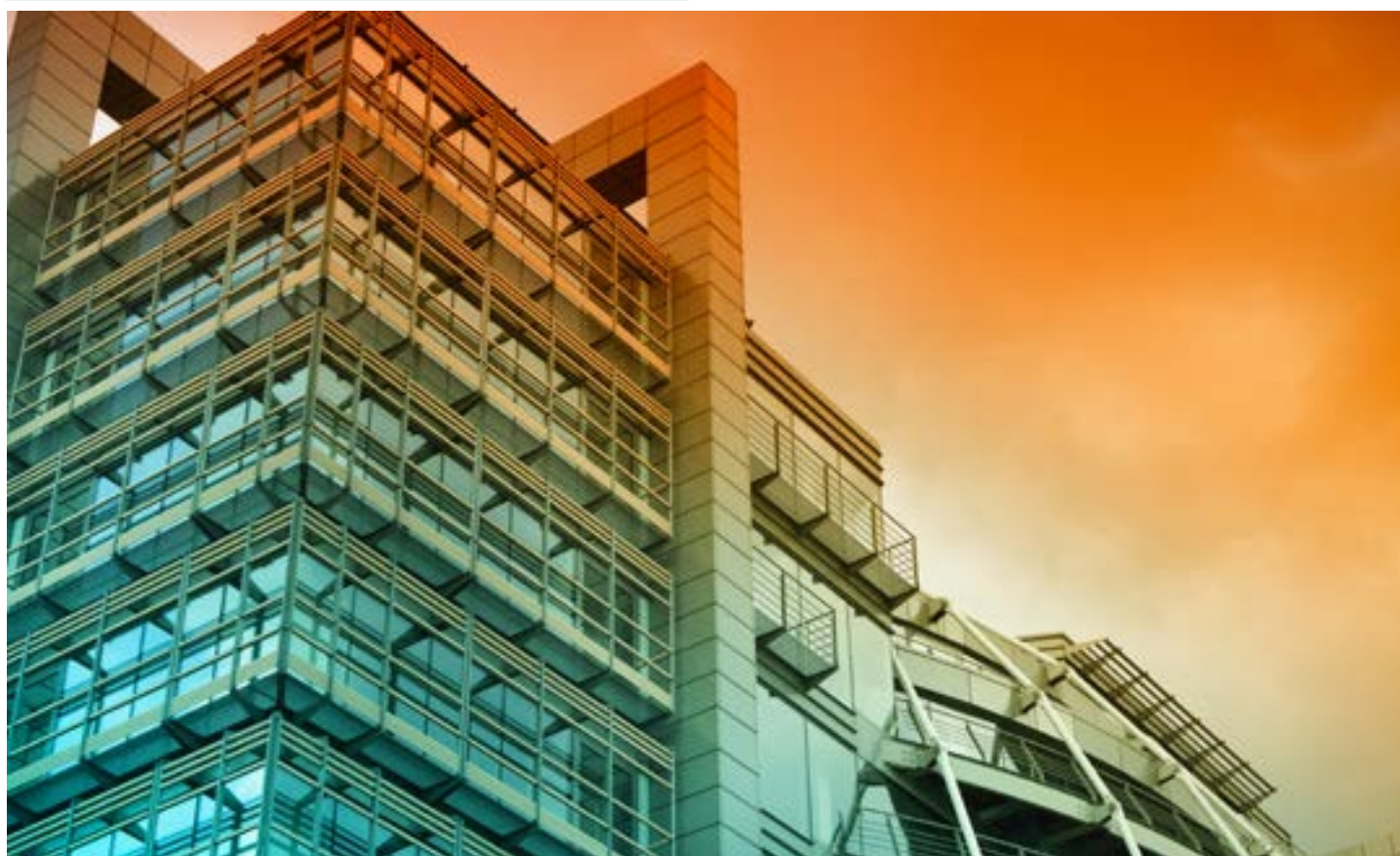
	AASB 118	IFRS 15
Revenue	\$1,000,000	\$750,000
Costs	\$500,000	\$500,000
Net profit	\$500,000	\$250,000

30 June 2019

	AASB 118	IFRS 15
Revenue	\$2,000,000	\$2,250,000
Costs	\$1,500,000	\$1,500,000
Net profit	\$500,000	\$750,000

Practical implications

The impacts of IFRS 15 are not only the significant changes in the patterns of revenue and profit recognition as the above examples have shown. Systems and processes will also have to change to deduct the costs of significant equipment/material and mobilisation costs in calculating % of progress to date. Entities in the construction industry will also need to think about how to account for penalties and performance bonus payments in construction contracts, as well as its policy and processes for estimating the expected or most likely value, and revising the estimate at each reporting date.



APPENDIX A

The following two tables summarise the revenue and profit recognised for each of the reporting periods under AASB 118 Revenue and the new IFRS 15 standard.

AASB 118 REVENUE	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
Contract price	\$5,000,000	\$5,000,000	\$7,000,000	\$7,000,000	\$7,000,000	
Costs incurred this period	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	
Costs incurred to date	\$1,500,000	\$2,500,000	\$3,500,000	\$4,500,000	\$5,500,000	
Total estimated contract costs	\$4,000,000	\$4,000,000	\$5,500,000	\$5,500,000	\$5,500,000	
Stage of completion	37.50%	62.50%	63.64%	81.82%	100.00%	
Revenue to date	\$1,875,000	\$3,125,000	\$4,454,545	\$5,727,273	\$7,000,000	
Revenue recognised in prior periods	0	\$1,875,000	\$3,125,000	\$4,454,545	\$5,727,273	
Revenue for the period	\$1,875,000	\$1,250,000	\$1,329,545	\$1,272,727	\$1,272,727	\$7,000,000
Costs for the period	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$5,500,000
Profit for the period	\$375,000	\$250,000	\$329,545	\$272,727	\$272,727	\$1,500,000

IFRS 15 REVENUE	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
Contract price	\$4,930,000	\$4,950,000	\$6,880,000	\$7,000,000	\$7,000,000	
Uninstalled materials						
Contract price allocated to uninstalled materials	\$1,500,000	\$1,500,000	\$2,500,000	\$2,500,000	\$2,500,000	
Costs of uninstalled material incurred this period	\$1,500,000	\$0	\$0	\$0	\$1,000,000	
Revenue for the period	\$1,500,000	\$0	\$0	\$0	\$1,000,000	
Refurbishment						
Contract price allocated to refurbishment	\$3,430,000	\$3,450,000	\$4,380,000	\$4,500,000	\$4,500,000	
Refurbishment costs incurred this period	\$0	\$1,000,000	\$1,000,000	\$1,000,000	\$0	
Refurbishment costs incurred to date	\$0	\$1,000,000	\$2,000,000	\$3,000,000	\$3,000,000	
Total estimated refurbishment costs	\$2,500,000	\$2,500,000	\$3,000,000	\$3,000,000	\$3,000,000	
% of costs incurred to date	0.00%	40.00%	66.67%	100.00%	100.00%	
Revenue to date for refurbishment	\$0	\$1,380,000	\$2,920,000	\$4,500,000	\$4,500,000	
Revenue recognised in prior periods for refurbishment	\$0	\$0	\$1,380,000	\$2,920,000	\$4,500,000	
Revenue for the period for refurbishment	\$0	\$1,380,000	\$1,540,000	\$1,580,000	\$0	
Total revenue for the period	\$1,500,000	\$1,380,000	\$1,540,000	\$1,580,000	\$1,000,000	\$7,000,000
Total costs for the period	\$1,500,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$5,500,000
Profit for the period	\$0	\$380,000	\$540,000	\$580,000	\$0	\$1,500,000