Applying IFRS in Engineering and Construction

The new revenue recognition standard

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What you need to know

- IFRS 15 creates a single source of revenue recognition requirements for all entities in all industries. The new revenue standard is a significant change from current IFRS.

- The new standard applies to revenue from contracts with customers and replaces all of the revenue standards and interpretations in IFRS, including IAS 11, IAS 18 and related Interpretations (e.g., IFRIC 15).

- IFRS 15 also specifies the accounting treatment for certain items not typically thought of as revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets.

- While many of the principles in the new standard are similar to today's requirements, entities should not assume that the pattern of revenue recognition for their arrangements will be unchanged. E&C entities may be required to make additional judgements that they have not had to make under current IFRS.

- Key issues for the E&C industry include identifying performance obligations, accounting for contract modifications, applying the constraint to variable consideration, evaluating significant financing components, measuring progress toward satisfaction of a performance obligation, recognising contract cost assets and addressing disclosure requirements.

- Both the IASB and FASB decided to propose a one-year deferral of the effective date for the revenue standards. For IFRS 15, the effective date will therefore be 1 January 2018.
Overview

Engineering & Construction (E&C) entities may need to change their revenue recognition policies and practices as a result of the new revenue recognition standard, IFRS 15 Revenue from Contracts with Customers. The new standard is a result of a joint project issued by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB)\(^1\) (collectively, the Boards). IFRS 15 will supersede virtually all revenue recognition requirements that E&C entities may use today. E&C entities will no longer have to consider whether contracts are in the scope of IAS 11 Construction Contracts or IAS 18 Revenue. Also, the revenue related Interpretation IFRIC 15 Agreements for the Construction of Real Estate will be superseded.

IFRS 15 specifies the accounting for all revenue arising from contracts with customers. It affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRS requirements, such as IAS 17 Leases). The standard also provides a model for the recognition and measurement of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment and intangible assets.

While many of the concepts in the new model are consistent with those in current IFRS for recognising revenue from construction contracts in IAS 11, the requirements for accounting for certain elements of E&C contracts will change. In addition, IFRS 15 introduces a number of new disclosure requirements that E&C entities will need to evaluate.

This publication highlights key considerations for construction contractors and other entities that provide design and engineering services for infrastructure and real estate projects and currently apply IAS 11.

This publication supplements our Applying IFRS, A closer look at the new revenue recognition standard (June 2014)\(^2\) (general publication) and should be read in conjunction with that publication.

E&C entities may also wish to monitor the discussions of the Boards’ Joint Transition Resource Group for Revenue Recognition (TRG).\(^3\) The Boards created the TRG to support stakeholders with implementation of the new standard. It was also created to help the Boards determine whether additional interpretation, application guidance or education is needed on implementation issues and other matters submitted by stakeholders. The TRG will not make formal recommendations to the Boards or issue application guidance. Any views discussed by the TRG are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and as entities begin to apply it and our views may evolve during that process.

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\(^{1}\) Accounting Standards Update 2014-09, Revenue from Contract with Customers (largely codified in Accounting Standards Codification (ASC) 606).

\(^{2}\) Available on [www.ey.com/ifrs](http://www.ey.com/ifrs).

\(^{3}\) IFRS Developments and Applying IFRS covering the discussions of the TRG are available on [www.ey.com/ifrs](http://www.ey.com/ifrs).
1. Summary of the new standard

IFRS 15 specifies the requirements an entity must apply to measure and recognise revenue. The core principle of the standard is that an entity will recognise revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer.

The principles of IFRS 15 are applied using the following five steps:

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

An entity will need to exercise judgement when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity must also apply the requirements of IFRS 15 consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity will generally need to disclose more information than it does under current IFRS. Annual disclosures will include qualitative and quantitative information about the entity’s contracts with customers, significant judgements made (and changes in those judgements) and contract cost assets.

2. Effective date and transition

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted for IFRS preparers and first-time adopters of IFRS.

For public entities applying US GAAP, the equivalent revenue recognition standard is effective for reporting periods beginning after 15 December 2016. However, US public entities are not permitted to early adopt the standard.

At their separate July 2015 meetings, both the IASB and the FASB agreed to a one-year deferral of the effective date for the revenue standards. Early adoption is still permitted for IFRS reporting entities.

All entities will be required to apply the standard retrospectively, using either a full retrospective or a modified retrospective approach.

- The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

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4 US non-public entities will be required to apply the new standard to reporting periods beginning after 15 December 2017. Early adoption is permitted, but not prior to reporting periods beginning after 15 December 2016.

5 Refer to IFRS Developments Issue 110: IASB decides to defer the new revenue standard by one year available on www.ey.com/ifrs for more details.
Under the modified retrospective approach, financial statements will be prepared for the year of adoption using IFRS 15, but prior periods will not be adjusted. Instead, an entity will recognise a cumulative catch-up adjustment to opening retained earnings (or other appropriate component of equity) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). In addition, an entity will be required to disclose, for all affected line items in the current reporting period, the amount by which those line items are affected by the application of IFRS 15 as compared to the standards and interpretations that were in effect (i.e., IAS 18, IAS 11 and related Interpretations).

For more information about the effective date and transition options, see Section 1 of our general publication.

How we see it
Before determining a transition approach, an E&C entity must understand the new revenue model and develop a plan for analysing how the standard will affect the accounting for its revenue contracts. Both of the transition methods have pros and cons that will affect individual entities in different ways, depending on the characteristics of their contracts (e.g., consideration type, number of performance obligations, contract length).

Analysing transition approaches will also help entities determine whether they will need to change their systems, processes and controls to account for revenue under the new standard. We expect that any such changes, along with activities such as training personnel and educating analysts and external stakeholders, could require a significant investment of time and capital.

3. Scope
IFRS 15 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts, which are specifically excluded from the scope:

- Lease contracts within the scope of IAS 17
- Insurance contracts within the scope of IFRS 4 Insurance Contracts
- Financial instruments and other contractual rights or obligations within the scope of IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement, IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

Entities may enter into transactions that are partially within the scope of IFRS 15 and partially within the scope of other standards. In these situations, the standard requires an entity to apply any separation and/or measurement principles in the other standard first, before applying IFRS 15 (see Section 7).
4. Identify the contract with the customer

The model in IFRS 15 applies to each contract with a customer. Contracts may be written, oral or implied by an entity’s customary business practices, but must be legally enforceable and meet specified criteria, which are discussed in Section 3.1 of our general publication. An entity is required to combine two or more contracts that it enters into at, or near, the same time with the same customer and account for them as a single contract, if they meet specified criteria (see Section 4.1 below).

An assessment of collectability is one of the criteria for determining whether a contract with a customer exists, i.e., an entity must conclude that it is probable that it will collect the consideration to which it expects to be entitled. The amount of consideration to which an entity expects to be entitled (i.e., the transaction price) may differ from the stated contract price (e.g., if an entity intends to offer a concession and accept an amount less than the contractual amount). When performing the collectability assessment, an entity only considers the customer’s ability and intention to pay the expected consideration when due.

How we see it

Significant judgement will be required to determine whether a contract is within the scope of IFRS 15 if an entity believes it will receive partial payment for performance. The entity will be required to determine whether the amount of consideration that it does not expect to receive is a price concession or an amount that the customer does not have the ability and intention to pay.

In making this determination, an entity will have to consider whether its customary business practices, published policies or specific statements provide the customer with a valid expectation that the entity will accept an amount of consideration that is less than the price stated in the contract.

If an entity concludes that it has met all of the criteria for a contract under IFRS 15, it will not reassess the criteria unless there is an indication of a significant change in facts and circumstances. An example of this scenario is included in the standard relating to the significant deterioration in a customer’s ability to pay the consideration when due. Entities in this situation will need to determine whether it is still probable that they will be able to collect the amount of consideration to which they are entitled, or the contract may no longer be a contract under IFRS 15. E&C entities will need to apply significant judgement in these circumstances.

IFRS 15 provides requirements for entities to follow when an arrangement does not meet the criteria of a contract under the standard. Any consideration received from a customer (e.g., an advance payment) before the contract criteria have been satisfied is initially accounted for as a liability (not revenue).
If an entity enters into an arrangement that does not meet the criteria for a contract under IFRS 15, revenue can only be recognised when either: (1) the entity has no remaining obligations to transfer goods or services and substantially all of the consideration has been received by the entity and is non-refundable; or (2) the contract has been terminated and the consideration received is non-refundable.

In January 2015, the TRG debated the issue of when an entity would recognise revenue if it determines (either at contract inception or upon reassessment) that collectability is not probable. Several TRG members noted that this requirement could potentially indefinitely delay recognition of non-refundable cash consideration received in a number of situations (e.g., a month-to-month service arrangement when the entity continues to perform). These TRG members questioned whether this was the Boards’ intent.

At the March 2015 joint Board meeting, the FASB tentatively decided to clarify that a contract would be terminated when an entity has the ability to stop transferring goods or providing services and has actually done so. At its April 2015 meeting, the IASB agreed not to make any clarifications or amendments to IFRS 15. In making its decision, the IASB noted that sufficient guidance exists in IFRS 15 and that practice would likely develop to reach the same conclusion as that reached by the FASB at the March 2015 meeting.

4.1 Combining contracts

Under IFRS 15, an entity will generally apply the model to an individual contract with a customer. However, IFRS 15 requires entities to combine contracts entered into at or near the same time with the same customer if they meet one or more of the following criteria:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation (see Section 5 for a discussion on identifying performance obligations).

The Boards clarified that negotiating multiple contracts at the same time is not sufficient evidence to demonstrate that the contracts represent a single arrangement.

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6 Our publications, IFRS Developments and Applying IFRS covering the discussions of the TRG are available on www.ey.com/ifrs.
7 Refer to IFRS Developments Issue 104: IASB and FASB decide to make more changes to their new revenue standard available on www.ey.com/ifrs for more details.
8 IfRS 15.BC73.
Overall, the criteria for combining contracts are generally consistent with the underlying principles in the existing revenue standards. However, IFRS 15 provides more application guidance on when to combine contracts than IAS 18 and, unlike IAS 18, the new standard explicitly requires an entity to combine contracts if the criteria are met. Therefore, some entities that do not currently combine contracts may need to do so.

The criteria in IAS 11 and IFRS 15 are similar. However, unlike IAS 11, IFRS 15 does not require concurrent or sequential performance. Furthermore, IAS 11 requires that all criteria be met before combining contracts. Whereas, IFRS 15 only requires that one or more of the criteria be met.

4.2 Contract modifications

A contract modification is a change in the scope or price (or both) of a contract. An entity must determine whether the modification creates a new contract or whether it will be accounted for as part of the existing contract. The determination of a new and separate contract is driven by whether the modification results in the addition of distinct goods or services, priced at their stand-alone selling prices (see Section 7).

Parties to E&C arrangements frequently agree to change orders that modify the scope or price (or both) of a contract. Contractors also regularly submit claims to customers when unanticipated additional costs are incurred as a result of delays, errors or changes in scope caused by the customer. IFRS 15 states that “a contract modification exists when the parties to a contract approve a modification that either creates new, or changes existing, enforceable rights and obligations of the parties to the contract”. Approvals of a modification may be written, oral or implied by the entity’s customary business practices.

Generally, if a contract modification has not been approved, IFRS 15 is not applied to the modification until the approval occurs. However, the standard also states that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both). Instead of focusing on the finalisation of a modified agreement, these requirements focus on the enforceability of the changes to the rights and obligations in the contract. That is, once the entity determines that the revised rights and obligations are enforceable, the entity is required to account for the contract modification. If the parties to a contract have approved a change in the scope of the contract, but have not yet determined the corresponding change in price, an entity will have to estimate the change to the transaction price arising from the modification in accordance with the requirements for estimating variable consideration (see Section 6.1).

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9 IAS 11.9(c).
10 IFRS15.18.
The standard provides the following example to illustrate this point:

**Extract from IFRS 15**

Example 9 — Unapproved Change in Scope and Price (IFRS 15.IE42-IE43)

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

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

Once an entity has determined that a contract has been modified (e.g., because of a change order or claim), the entity has to determine the appropriate accounting for the modification. Certain modifications are treated as separate stand-alone contracts, while others are combined with the original contract and accounted for in that manner.

An entity is required to account for a contract modification as a separate contract, with no effect on the original contract, if:

(i) The scope of the contract increases because of the addition of promised goods or services that are distinct (see Section 5)

And

(ii) The price of the contract increases by an amount of consideration that reflects the entity’s stand-alone selling prices of the additional promised goods or services

In these circumstances, the stand-alone selling prices of the additional goods or services may include adjustments that reflect the circumstances of the particular contract (e.g., a discount provided to a customer because materials and equipment needed for a change order are already on site). See Illustration 4-1 below for an example.
If a contract modification is not accounted for as a separate contract, an entity would account for the promised goods or services not yet transferred at the date of the contract modification (including those in the original contract) in whichever of the following ways is applicable:

- A termination of the old contract and the creation of a new contract (i.e., on a prospective basis), if the remaining goods and services after the contract modification are distinct, but the consideration does not reflect the stand-alone selling price of those goods or services. See Illustration 4-1 below.

- A continuation of the original contract if the remaining goods and services to be provided after the contract modification are not distinct (and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification). Such modifications are accounted for on a cumulative catch-up basis. See Illustration 4-1 below.

- Finally, a change in a contract may also be treated as a combination of the two: a modification of the existing contract and the creation of a new contract. In this case, an entity would not adjust the accounting for completed performance obligations that are distinct from the modified goods or services. However, the entity would adjust revenue previously recognised (either up or down) to reflect the effect of the contract modification on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and the measure of progress.

The requirement to determine whether to treat a change in contractual terms as a separate contract or a modification to an existing contract is generally consistent with current requirements in IAS 11. For example, IAS 11 requires that a contract modification that includes the construction of an additional asset be treated as separate construction contract when certain criteria are met (e.g., when the asset differs significantly from the assets covered by the original contract or the price of the asset is negotiated without regard to the original contract price).\(^1\)

When assessing how to account for a contract modification, an entity must consider how any revisions to promised goods or services interact with the rest of the contract. That is, although a change order may add a new good or service that would be distinct in a stand-alone transaction, the new performance obligation may not be distinct in the context of the modified contract. For example, in a building construction project, a customer may request a change order to add an additional floor. The construction entity may commonly perform construction services to add a new floor to an existing, completed building, which would likely be considered a distinct service in those contracts. However, when that service is added to an existing contract (e.g., a contract to construct the entire building) and the entity has already determined that the entire project is a single performance obligation, the added goods and services would normally be combined with the existing bundle of goods and services.

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\(^1\) IAS11.10.
The following example illustrates an entity’s potential analysis of the accounting treatment for a contract modification:

<table>
<thead>
<tr>
<th>Illustration 4-1</th>
<th>Modification of a construction contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractor E agrees to construct a manufacturing facility on a customer’s land for CU10 million. During construction, the customer determines that a separate storage facility is needed at the location. The parties agree to modify the contract to include the construction of the storage facility, to be completed within three months of completion of the manufacturing facility, for a total price of CU11 million.</td>
<td></td>
</tr>
</tbody>
</table>

**Scenario A**

When the contract is modified, an additional CU1 million is added to the consideration that Contractor E will receive. Contractor E would normally charge CU1.1 million to construct a similar facility. However, much of the equipment and labour force necessary to complete construction of the storage facility is already onsite and available for use by Contractor E. Therefore, the additional CU1 million reflects the stand-alone selling price at contract modification, adjusted for the particular circumstances of the contract.

Assuming that Contractor E determines that the construction of the separate storage facility is a distinct performance obligation, the contract modification for the additional storage facility would be, in effect, a new (separate) contract that does not affect the accounting for the existing contract.

**Scenario B**

As in Scenario A, the contract is modified when Contractor E agrees to build the storage facility and the customer agrees to pay an additional CU1 million.

Again assume that Contractor E determines that the construction of the separate storage facility is a distinct performance obligation. However, Contractor E determines that it would normally charge CU1.5 million to construct a similar facility. While Contractor E can attribute some of the discount to its ability to use equipment and labour resources that are already on site, the price reduction was primarily driven by other factors (such as Contractor E’s desire to maintain the customer relationship and keep its resources deployed). Therefore, the additional CU1 million does not reflect the stand-alone selling price at contract modification.

Assume that Contractor E concludes that it transfers control of each facility over time. As a result, Contractor E accounts for the modification as a modification of the existing contract. The revised transaction price of CU11 million is allocated between the two performance obligations in the modified contract (being the original incomplete performance obligation to construct the manufacturing facility and the new performance obligation to construct the storage facility). The transaction price is allocated based on the relative stand-alone selling prices of each performance obligation (see Section 7). Any revenue previously recognised for the manufacturing facility is adjusted on a cumulative catch-up basis to reflect the allocated transaction price. Revenue from the construction of the storage facility (i.e., a separate performance obligation) is recognised based on the appropriate measure of progress.
In practice, a contractor that is already performing work on a project may have leverage that provides it with the ability to charge a higher price for a change order than it otherwise would if the activities were performed on a stand-alone basis. This may be because, for example, the customer does not enter into an open bidding process for each individual change order. In these circumstances, determining whether the consideration from the modification reflects the stand-alone selling price of the activities will require significant judgement.

The following example from the standard illustrates a contract modification that is accounted for as part of the original contract:

**Extract from IFRS 15**

Example 8 — Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue (IFRS 15.IE37-IE41)

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of CU1 million and a bonus of CU200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 35(b) of IFRS 15 because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction price</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Expected costs</td>
<td>700,000</td>
</tr>
<tr>
<td>Expected profit (30%)</td>
<td>300,000</td>
</tr>
</tbody>
</table>

At contract inception, the entity excludes the CU200,000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Completion of the building is highly susceptible to factors outside the entity’s influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress towards complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 per cent of its performance obligation on the basis of costs incurred to date (CU420,000) relative to total expected costs (CU700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 56–58 of IFRS 15. Consequently, the cumulative revenue and costs recognised for the first year are as follows:

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>600,000</td>
</tr>
<tr>
<td>Costs</td>
<td>420,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>180,000</td>
</tr>
</tbody>
</table>
In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by CU150,000 and CU120,000, respectively. Total potential consideration after the modification is CU1,350,000 (CU1,150,000 fixed consideration + CU200,000 completion bonus). In addition, the allowable time for achieving the CU200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognised in accordance with paragraph 56 of IFRS 15 and includes the CU200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 27(b) of IFRS 15 and concludes (on the basis of the factors in paragraph 29 of IFRS 15) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 21(b) of IFRS 15). The entity updates its measure of progress and estimates that it has satisfied 51.2 per cent of its performance obligation (CU420,000 actual costs incurred + CU820,000 total expected costs). The entity recognises additional revenue of CU91,200 [(51.2 per cent complete × CU1,350,000 modified transaction price) – CU600,000 revenue recognised to date] at the date of the modification as a cumulative catch-up adjustment.

How we see it
E&C entities will need to carefully evaluate performance obligations at the date of a modification to determine whether the remaining goods or services to be transferred are distinct and the prices are commensurate with their stand-alone selling prices. This assessment is important because the accounting treatment can vary significantly depending on the conclusions reached. See further discussion of identifying performance obligations in Section 5.
5. Identify the performance obligations in the contract

Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify all the promised goods or services within the contract and determine which of those promised goods or services (or bundles of promised goods or services) will be treated as separate performance obligations.

IFRS 15 identifies several activities common to E&C entities that are considered promised goods and services, including the construction, manufacture or development of an asset on behalf of a customer and the performance of a contractually agreed-upon task for a customer (e.g., design and engineering services).

The criteria in IFRS 15 for identifying performance obligations differ from the limited guidance in IAS 11, which could result in different conclusions about the separately identifiable components. For example, today a contractor may consider an entire contract to be a single component, but under IFRS 15, it may determine that the contract contains two or more performance obligations that would be accounted for separately. These judgements may be more complex when, for example, a construction contract also includes design, engineering or procurement services.

Separate performance obligations represent promises to transfer to the customer either:

- A good or service (or a bundle of goods and services) that is distinct
- A series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer

5.1 Determination of distinct

IFRS 15 outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct:

- Assessment at the level of the individual good or service (i.e., the good or service is capable of being distinct)
- Assessment of whether the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

Both of these criteria must be met to conclude that the good or service is distinct and, when met, the individual components must be separated. This means the transaction price will be allocated to these performance obligations and each performance obligation must be satisfied in order to recognise revenue.

In many cases, goods or services are capable of being distinct, but may not be distinct in the context of the contract. The standard provides factors to help entities determine whether goods or services in a bundle of promised goods and services would be combined as one performance obligation (i.e., are not distinct in the context of the contract). These factors, if present, would indicate that a bundle of goods and services are separately identifiable:

- The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle that represents the combined output for which the customer has contracted.
The good or service does not significantly modify or customise another good or service promised in the contract.

The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract.

The Boards concluded that a good or service is not separable from other promises in the contract when an entity provides an integration service to incorporate individual goods and/or services into a combined output. The Boards observed that this may be relevant in many construction contracts if a contractor provides an integration service to manage and coordinate the various construction tasks and to assume the risks associated with the integration of those tasks.

If an entity determines that a promised good or service is not distinct, the entity has to combine that good or service with other promised goods or services until a distinct bundle of goods or services is formed. This distinct bundle is accounted for as a single performance obligation.

How we see it
Properly identifying performance obligations within a contract is a critical component of the revenue model because revenue allocated to each performance obligation is recognised as the obligation is satisfied.

E&C entities, particularly those with long-term construction contracts, should carefully assess whether applying the new requirements results in the identification of performance obligations that are different from the separately identifiable components assessed under IAS 11 or IAS 18. These differences may result in a change in the pattern of revenue recognition and associated profit.

E&C entities will likely find that evaluating whether a good or service is distinct within the context of the contract will be a significant aspect of implementing the new standard. Entities should follow ongoing implementation efforts of the TRG and the Boards for further insights that may be provided on this topic.12

5.2 Series of distinct goods and services that are substantially the same and that have the same pattern of transfer
Goods and services that are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer must be accounted for as a single performance obligation if both of the following criteria are met:

• Each distinct good or service in the series that the entity promises to transfer represents a performance obligation that would be satisfied over time (see Section 8.1) if it were accounted for separately.

• The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see Section 8.1.4).

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12 Refer to our publication IFRS Developments 102: Boards reach different decisions on some of the proposed changes to the new revenue standards (February 2015) for a summary of recent Board discussions on identification of performance obligations.
For contracts with variable consideration (e.g., performance bonuses or fees earned based on hours incurred), identifying a series of distinct services as a single performance obligation could have a significant effect because, if certain criteria are met, variable consideration will be allocated to one or more, but not all, distinct services in a performance obligation. See Section 7 for further discussion on allocating variable consideration.

The Boards have provided examples of services that may represent a series of goods or services that would be accounted for as a single performance obligation such as a cleaning contract, asset management services, transaction processing services and a contract to deliver electricity. It is unclear how these requirements will be applied to a series of goods or to services that are not repetitive.

For example, when an entity enters into a two-year contract to provide engineering services, it will need to determine whether: the services it provides are substantially the same over the term of the contract (i.e., while the specific activities that occur each day may vary slightly, the overall service of providing engineering services is substantially the same); have the same pattern of transfer; and meet both of the criteria above. If all of these requirements are met, the contract represents one performance obligation. In contrast, if the entity determines that it provides distinct services in the contract (e.g., planning, design, construction support) that are not all substantially the same, it may identify multiple performance obligations. If an entity determines that these activities represent separate performance obligations, the transaction price must be allocated to each performance obligation (see Section 7 for further discussion of allocating the transaction price).

**How we see it**

Because the standard does not explain what is meant by the phrase “same pattern of transfer”, judgement will be required to evaluate whether project management, construction supervision or engineering services provided by E&C entities meet this criterion. E&C entities should follow implementation efforts that may clarify the types of services that have the same pattern of transfer.

5.3 Principal versus agent considerations

Some E&C contracts (e.g., project management, procurement arrangements) contain provisions under which an entity’s customer receives goods or services from another entity that is not a direct party to the contract. IFRS 15 states that when other parties are involved in providing goods or services to an entity’s customer, the entity must determine whether its performance obligation is to provide the good or service itself (i.e., the entity is a principal) or to arrange for another party to provide the good or service (i.e., the entity is an agent). The determination of whether the entity is acting as a principal or an agent will affect the amount of revenue the entity recognises. That is, when the entity is the principal in the arrangement, the revenue recognised is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognised is the net amount the entity is entitled to retain in return for its services as the agent. The entity’s fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.
A principal’s performance obligations in an arrangement differ from an agent’s performance obligations. For example, if an E&C entity obtains control of building materials from another party before it transfers (i.e., installs) those materials to the customer, the entity’s performance obligation may be to provide the goods or services itself as part of a larger performance obligation (e.g., to construct a building). Hence, the entity may be acting as a principal and would recognize revenue in the gross amount to which it is entitled. In contrast, an entity that obtains control of materials only momentarily before control is transferred to the customer is not necessarily acting as a principal. For example, if an E&C entity is acting as a project manager and facilitates materials procurement or identifies trade contractors for the customer in exchange for a fee or commission and does not control the goods or services for any length of time, the performance obligation is likely to arrange for another party to provide the goods or services to the customer and the entity is likely acting as an agent.

Because it is not always clear which party is the principal in a contract, the Boards provided the following indicators of when a performance obligation involves an agency relationship:

- Another party is primarily responsible for fulfilling the contract.
- The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return.
- The entity does not have discretion in establishing prices for the other party’s goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.
- The entity’s consideration is in the form of a commission.
- The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party’s goods or services.

The Boards noted that these indicators are based on indicators that are in today’s revenue recognition requirements in IFRS and US GAAP. However, the indicators in IFRS 15 have a different purpose in that they are based on the concepts of identifying performance obligations and the transfer of control of goods or services.

**How we see it**

E&C entities will need to carefully evaluate whether a gross or net presentation is appropriate. Although the new standard includes application guidance that is similar to existing requirements, there are some notable differences that may affect an entity’s principal-agent judgements and conclusions. For example, the standard requires an entity to consider whether it has control of the goods and services as part of the evaluation. Entities will need to use judgement to determine which indicators are most important based on the facts and circumstances.

13 IFRS 15.BC382
6. Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. This amount is meant to reflect the amount to which the entity has rights under the present contract, which may differ from the contractual price (e.g., if the entity intends to offer a price concession).

The consideration promised in a contract may include fixed or variable amounts. When determining the transaction price, entities must estimate, at contract inception, the variable consideration to which they expected to be entitled. However, IFRS 15 requires that entities constrain the variable consideration included in the transaction price to the amount for which it is highly probable that a significant reversal of revenue will not occur. The transaction price will also include any non-cash consideration (e.g., customer-furnished materials for which control is transferred to the entity); consideration paid or payable to a customer; and the effect of a significant financing component (i.e., the time value of money). Refer to Sections 5.3, 5.4 and 5.5 of our general publication for further details.

6.1 Variable consideration

The transaction price may vary in amount and timing as a result of discounts, credits, price concessions, incentives or bonuses. In addition, consideration may be contingent on the occurrence or non-occurrence of a future event (e.g., a performance bonus).

An entity is required to estimate each type of variable consideration using either the ‘expected value’ (i.e., the sum of probability-weighted amounts) or the ‘most likely amount’ (i.e., the single most likely outcome). The entity selects whichever method better predicts the amount of consideration to which the entity expects to be entitled. That is, the method selected is not meant to be a free choice. An entity is required to apply the selected method consistently throughout the contract and for similar types of contracts. The entity must update the estimated transaction price at the end of each reporting period.

The Boards indicated\(^\text{14}\) that the most likely amount may be the better predictor when the entity expects to be entitled to one of only two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus, but not a portion of that bonus). The following example illustrates how an E&C entity may estimate variable consideration:

<table>
<thead>
<tr>
<th>Illustration 6-1 — Estimating variable consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>On 1 January 2017, Contractor M enters into a contract with Company B to construct a new corporate headquarters on land owned by Company B. Contractor M determines that control of the building is passed to Company B as it is constructed. Therefore, the performance obligation is satisfied over time (see Section 8). The contract price is CU25 million, but that amount will be reduced or increased depending on when construction of the building is completed. For each day before 30 June 2018 that the building is completed, the promised consideration will increase by CU25,000. For each day after 30 June 2018 that the building is incomplete, the promised consideration will be reduced by CU25,000.</td>
</tr>
</tbody>
</table>

\(^{14}\) IFRS15.53(b)
The parties have also agreed that, when the building is complete, it will be inspected and assigned a green building certification level. If the building achieves the certification level specified in the contract, Contractor M will be entitled to an incentive bonus of CU200,000.

Analysis

Contractor M has to determine whether the ‘expected value’ or ‘most likely amount’ better predicts the variable consideration it will receive. Contractor M determines that the ‘expected value’ is the better predictor of the variable consideration associated with the daily incentive or penalty (i.e., CU25 million, plus or minus CU25,000 per day) since multiple outcomes are possible. Assume for purposes of this illustration that the constraint (discussed further in Section 6.1.1 below) does not limit the amount that can be included in the transaction price.

Based on the current construction schedule and its experience with past projects, Contractor M estimates that it is 50% likely to complete the project 10 days ahead of schedule and receive an incentive of CU250,000, 25% likely to complete the project on time and receive no incentive, and 25% likely to complete the project five days past schedule and incur a CU125,000 penalty. Using a probability-weighted estimate, Contractor M would include CU93,750 [(CU250,000 x 50%) + (CU0 x 25%) - (CU125,000 x 25%)] in the transaction price associated with this contingent consideration.

Contractor M determines that the ‘most likely amount’ is the better predictor to estimate the variable consideration associated with the green building certification bonus because there are only two possible outcomes (CU200,000 or CU0). Based on its history of completing building projects that achieve the green building certification level specified in the contract and the absence of factors that may indicate the criteria will not be met, Contractor M includes the CU200,000 bonus in the transaction price. Therefore, Contractor M estimates the total transaction price, after consideration of the base fee, daily incentive or penalty and green building certification bonus to be CU25,293,750 (CU25,000,000 + CU93,750 + CU200,000) at contract inception.

Contractor M updates its estimate of the transaction price at the end of each subsequent reporting period. For example, as at 31 December 2017, after evaluating construction completed to date and the remaining project schedule, Contractor M determines it is now 75% likely to complete the project 10 days ahead of schedule and receive an incentive of CU250,000 and 25% likely to complete the project on time and receive no incentive. As a result, Contractor M updates its estimate of variable consideration from the daily incentive or penalty to CU187,500 [(CU250,000 x 75%) + (CU0 x 25%)] and adds CU93,750 (CU187,500 - CU93,750) to the transaction price.
6.1.1 Constraining estimates of variable consideration

To include variable consideration in the estimated transaction price, the entity has to first conclude that it is ‘highly probable’ that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. The Boards provided factors that may indicate that revenue will be subject to a significant reversal:

- The amount of consideration is highly susceptible to factors outside the entity’s influence (e.g., market volatility, judgement or actions of third parties, weather conditions).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity’s experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The indicators are not meant to be all-inclusive and entities may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not necessarily mean that it is highly probable that a change in the estimate of variable consideration will result in a significant revenue reversal.

For example, when determining whether variable consideration is constrained, E&C entities will need to consider a variety of factors. This may include the extent of their experiences with similar arrangements, uncertainties that may exist in the latter periods of a long-term contract and market and other factors that may be outside of their control (e.g., weather). E&C entities may find this evaluation to be especially difficult when determining whether variable consideration from contract claims will be included in the transaction price because one or more of the above indicators may be present. E&C entities will need to determine how the existence of such indicators affects their assessment of the constraint, which may be different for each individual claim since the risks associated with each claim could vary. All entities will want to make sure they sufficiently and contemporaneously document the reasons for their conclusions, including conclusions about both corroborating and contrary evidence.

When an entity is unable to conclude that it is highly probable that a change in the estimate of variable consideration that would result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when a contract includes variable consideration, an entity will update both its estimate of the transaction price and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at the end of each reporting period.
How we see it

While E&C entities may already estimate the variable consideration they expect to earn, they may need to change their processes for making those estimates and possibly their conclusions about when and how much variable consideration to include in the transaction price due to the constraint, when applying IFRS 15.

Furthermore, while the Boards noted that entities are required to evaluate the magnitude of a potential reversal relative to the total consideration (i.e., fixed and variable), they did not include any quantitative application guidance for evaluating ‘significance’. This will require entities to use judgement when making this assessment.

6.2 Customer-furnished materials

In many E&C arrangements, the customer may choose to procure and provide to the contractor certain materials that are necessary for the entity to complete a project. In other circumstances, the contractor may purchase and pay for the required materials using the customer’s procurement and purchase functions.

The new standard states that a customer’s contribution of goods or services (e.g., materials, equipment, labour) that are used in the fulfilment of a contract is a form of non-cash consideration if the contractor obtains control of the goods or services. The contractor has to evaluate whether it obtains control of the goods or services using the transfer of control requirements (see Section 8) in IFRS 15 and consider whether it is serving in the capacity of a principal or an agent (see Section 5.3).

When an entity receives, or expects to receive, non-cash consideration, the fair value of the non-cash consideration is included in the transaction price. The entity applies IFRS 13 Fair Value Measurement to measure the fair value of the non-cash consideration. If the entity cannot reasonably estimate the fair value of non-cash consideration, it is required to measure the non-cash consideration indirectly by reference to the estimated stand-alone selling price of the promised goods or services.

6.3 Significant financing component

A significant financing component may exist when the receipt of consideration does not match the timing of the transfer of goods or services to the customer (i.e., the consideration is prepaid or is paid well after the goods or services are provided). Entities will be required to adjust the transaction price for this component if the financing is significant to the contract. Entities will need to evaluate all relevant facts and circumstances when making this evaluation, including the difference between the promised consideration and the cash selling price of the promised goods or services and the combination of the expected length of time between the transfer of the goods and services and receipt of consideration and the prevailing interest rates in the relevant market.

The requirement to consider whether a significant financing component is present in a contract represents a significant change for E&C entities.

15 IFRS 15.BC217.
To reduce the burden of this requirement, the Boards included a practical expedient in the standard that allows entities to ignore a significant financing component when the period between the customer’s payment and the entity’s transfer of the goods or services is expected to be one year or less at contract inception.\textsuperscript{16} For example, billings in excess of costs that will be resolved within one year generally would not constitute a significant financing component.

The standard also states that a contract would not contain a significant financing component if the difference between the promised consideration and the cash selling price of the good or the service is due to reasons other than the provision of financing to either the entity or the customer (e.g., retainage). In addition, a significant financing component is not present if: (1) the customer pays for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer; or (2) a substantial amount of the consideration promised by the customer is variable and the amount or timing depends on the occurrence (or non-occurrence) of an event that is not substantially within the control of the customer or the entity.

When an entity concludes that a financing component is significant to a contract, it determines the transaction price by discounting the amount of promised consideration. The entity uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The discount rate has to reflect the credit characteristics of the borrower. The use of a rate that is explicitly stated in the contract, that does not correspond with market terms in a separate financing arrangement, would not be acceptable. Subject to certain limitations, the transaction price will need to be adjusted when there is a prepayment (e.g., an advanced payment) that is determined to be a significant financing component.

The standard provides the following illustration to assist entities in determining whether a significant financing component is present in a long-term contract:

\begin{center}
\textbf{Extract from IFRS 15}
\end{center}

\begin{quote}
**Example 27 — Withheld Payments on a Long-Term Contract** (IFRS 15.IE141-IIE142)

An entity enters into a contract for the construction of a building that includes scheduled milestone payments for the performance by the entity throughout the contract term of three years. The performance obligation will be satisfied over time and the milestone payments are scheduled to coincide with the entity’s expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (i.e., retained) by the customer throughout the arrangement and paid to the entity only when the building is complete.

The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity’s performance and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 62(c) of IFRS 15. The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.
\end{quote}

\textsuperscript{16} IFRS 15.63
How we see it

A significant financing component may exist in a contract even when there is no explicit purpose to finance between the parties (i.e., a significant financing component may be implicit). Entities will need to carefully evaluate certain payment terms common in E&C contracts (e.g., retainage, milestones, progress payments, award/incentive fees) and the timing of billings relative to when they expect to perform under the contract to determine whether a significant financing component exists.

Furthermore, the standard does not include any quantitative application guidance for evaluating whether a financing component is significant to the contract. This will require entities to use judgement when making this assessment. Entities will need to sufficiently document their analyses to support their conclusions.

7. Allocate the transaction price to the performance obligations

Once the performance obligations are identified and the transaction price has been determined, IFRS 15 requires (with some exceptions, as discussed below) an entity to allocate the transaction price to the performance obligations in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis).

To allocate the transaction price on a relative stand-alone selling price basis, an entity must first determine the stand-alone selling price (i.e., the price at which an entity would sell a good or service on a stand-alone basis at contract inception) for each performance obligation. The observable price of a good or service sold separately provides the best evidence of stand-alone selling price. However, in many situations, stand-alone selling prices will not be readily observable. In those cases, the entity estimates the stand-alone selling price.

The standard discusses three estimation methods: (1) the adjusted market assessment method; (2) the expected cost plus a margin method; and (3) the residual method. However, these are not the only estimation methods permitted. The standard allows an entity to use any reasonable estimation method (or combination of methods), as long as it is consistent with the notion of a stand-alone selling price, maximises the use of observable inputs and is applied consistently in similar circumstances.

Under the relative stand-alone selling price method, once an entity determines the stand-alone selling price for the performance obligations in a contract, the entity allocates the transaction price to those performance obligations, based on the proportion of the stand-alone selling price of each performance obligation, to the sum of the stand-alone selling prices of all of the performance obligations in the contract. The following example illustrates this allocation:
Illustration 7-1 — Allocating revenue to performance obligations

Contractor Z enters into an arrangement to build a retail shopping centre and detached car park for CU60 million. Assume that Contractor Z determines that the building and car park each represent performance obligations.

Analysis

To allocate the transaction price to the two performance obligations, Contractor Z must first determine the stand-alone selling price of the shopping centre and car park. Contractor Z builds similar structures on a regular basis and determines that the stand-alone selling prices of the shopping centre and car park are CU54 million and CU10 million, respectively. Contractor Z allocates the CU60 million transaction price on a relative basis as follows:

Shopping centre: CU50.63 million \[(CU54 million / CU64 million) \times CU60 million\]

Car park: CU9.37 million \[(CU10 million / CU64 million) \times CU60 million\]

Contractor Z recognises revenue allocated to each performance obligation based on the selected measure of progress for each (see Section 8.1.4).

7.1 Exceptions to the relative stand-alone selling price method

IFRS 15 requires an entity to use the relative stand-alone selling price method to allocate the transaction price, with two specific exceptions. The first exception requires an entity to allocate a discount in a contract only to the specific goods or services to which it relates, rather than proportionately to all of the separate performance obligations, if certain criteria are met.

The second exception requires variable consideration to be allocated entirely to a specific part of a contract (such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation), if both of the following criteria are met:

- The terms of a variable payment relate specifically to the entity’s efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the standard’s overall objective of allocating revenue in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An E&C entity that determines that a contract contains multiple performance obligations may use this exception if it concludes that variable consideration relates only to one performance obligation (or more than one, but not all performance obligations). For example, Illustration 4-1 describes a contract in which the contractor determined that the construction of manufacturing and storage facilities represented separate performance obligations. If the contract included an incentive fee for completing construction of the manufacturing facility ahead of schedule, the entity would allocate consideration from that incentive fee to the performance obligation representing the construction of the manufacturing facility alone (provided the contractor determined the total consideration allocated to this performance obligation depicts the amount to which it is entitled).

Entities that provide project management or engineering services may be able to allocate variable consideration to the period in which the related services were performed, if certain criteria are met.
In addition, E&C entities that provide project management, construction supervision or engineering services that are a series of distinct services that form part of a single performance obligation may be able to use this exception and, thereby, allocate variable consideration to distinct services within the series, if the above criteria are met. That is, an entity may receive variable consideration that relates specifically to an entity’s efforts to transfer services for a certain period within a single performance obligation (e.g., a day, a month or a quarter) that are distinct from the services provided in other periods within the performance obligation. If the criteria are met, the entity will be required to allocate that variable consideration only to those distinct periods, instead of allocating it to all distinct services within the series. For more information about applying the ‘Series of distinct goods and services that are substantially the same and have the same pattern of transfer’ exception, see Section 4.2.2 of our general publication.

The following example illustrates the application of the second exception related to variable consideration by an engineering services entity that determines that the services it is providing represent a single performance obligation:

**Illustration 7-2 — Engineering services with variable consideration**

On 1 January 2018, Engineer Co. X enters into a one-year contract with a government agency to provide engineering consultation services for a sewer project. Engineer Co. X receives a fee of CU100 for each hour incurred (i.e., variable consideration based on effort expended).

**Analysis**

Assume that Engineer Co. X concludes that the management services are a single performance obligation recognised over time because they are determined to be a series of distinct services that are substantially the same and that have the same pattern of transfer to the customer.

Engineer Co. X determines that the transaction price is allocated to the services provided within each reporting period because the hours incurred during the period relate specifically to the entity’s efforts to satisfy the performance obligation and the allocation is consistent with the objective of allocating an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised services.

For example, if Engineer Co. X provided 800 hours of services during the first quarter of 2018, revenue of CU80,000 (800 hours x CU100 per hour) would be recognised in the quarter ending 31 March 2018.

**How we see it**

E&C entities will need to evaluate their contracts to determine whether this allocation exception will apply to contracts that are based on an hourly rate, including contracts that an entity concludes contain only one performance obligation. Some entities may find that applying the exception (and, therefore, recognising fees that relate specifically to the entity’s efforts to transfer the service in a distinct period) is relatively straightforward. However, certain contracts may contain multiple forms of consideration that relate to a single performance obligation. For example, a contract could also include a fixed fee that would generally be recognised over the term of the contract using the entity’s selected measure of progress (e.g., time elapsed, hours incurred), which may differ from the pattern in which the variable consideration is earned and therefore recognised under the contract.
7.2 Changes in transaction price after contract inception
Changes in the total transaction price are allocated to the separate performance obligations on the same basis as the initial allocation. Stand-alone selling prices are not updated after contract inception.

However, if the contract is modified, the contract modification requirements discussed in Section 4.2 must be followed. Depending on the facts and circumstances, the application of modification requirements could result in a need to update the stand-alone selling prices. Changes in the transaction price resulting from the modification would also be subject to those requirements.

When contracts include variable consideration, it is possible that changes in the transaction price that arise after a modification may (or may not) be related to performance obligations that existed before the modification. For changes in the transaction price arising after a contract modification, when contract modification was not treated as a separate contract, an entity must apply one of the following approaches:

- If the change in transaction price is attributable to an amount of variable consideration promised before the modification, and the modification was considered a termination of the existing contract and the creation of a new contract, the entity allocates the change in transaction price to the performance obligations that existed before the modification.
- In all other cases, the change in the transaction price is required to be allocated to the performance obligations in the modified contract (i.e., the performance obligations that were unsatisfied and partially unsatisfied immediately after the modification).

8. Satisfaction of performance obligations

Under IFRS 15, an entity recognises revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Control of the good or service refers to the ability to direct its use and to obtain substantially all of its remaining benefits (i.e., right to cash inflows or reduction of cash outflows generated by the good or service). Control also means the ability to prevent other entities from directing the use of and receiving the benefit from, a good or service.

The change to a control model under IFRS 15 will require E&C entities to carefully assess when revenue can be recognised. The standard indicates that an entity has to determine at contract inception whether it will transfer control of a promised good or service over time, regardless of the length of the contract or other factors. Depending on the measure of progress the entity applies (see Section 8.1.4), the accounting treatment for a contract that meets the criteria for recognition of revenue over time may be similar to the method it currently applies under existing requirements in IAS 11 (e.g., percentage-of-completion).

If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.
8.1 Performance obligations satisfied over time

An entity transfers control of a good or service over time (rather than at a point in time) when any of the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs.
- The entity’s performance creates or enhances an asset (e.g., work in progress) that the customer controls as the asset is created or enhanced.
- 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.

If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time (see Section 8.2).

8.1.1 Customer simultaneously receives and consumes benefits as the entity performs

In some instances, the assessment of whether a customer simultaneously receives and consumes the benefits of an entity’s performance will be straightforward (e.g., maintenance services for which the simultaneous receipt and consumption by the customer is readily evident). However, in some circumstances simultaneous receipt and consumption is less evident. The standard clarifies that revenue recognition over time is still appropriate if “an entity determines that another entity would not need to substantially reperform the work that the entity completed to date if that other entity were to fulfil the remaining performance obligation to the customer”.\(^\text{17}\) In making this determination, entities would not consider practical or contractual limitations that limit transfer of the remaining performance obligation.

As discussed in the Basis for Conclusions, the Boards created this criterion to clarify that, in pure service contracts, entities generally transfer services over time. In addition, the Boards intend that this criterion only apply to services and not to goods.\(^\text{18}\) As a result, the Boards note that an entity does not apply this requirement to determine whether a performance obligation is satisfied over time if the entity’s performance creates an asset the customer does not consume completely as it is received. Instead, an entity assesses that performance obligation using the criteria discussed in Sections 8.1.2 and 8.1.3.

E&C entities that provide project management, construction supervision or engineering services will need to carefully evaluate their contracts to determine whether the services performed are simultaneously received and consumed by the customer. It may be apparent that activities such as day-to-day site supervision services meet the criteria for recognition of revenue over time. These judgements may also be affected by an entity’s conclusion about the number of performance obligations (i.e., single or multiple) within the contract (see Section 5.1).

\(^{17}\) IFRS 15.B4.
\(^{18}\) IFRS 15.BC125.
8.1.2 Customer controls asset as it is created or enhanced

The second criterion in which the control of a good or service is transferred over time is where the customer controls the asset as it is being created or enhanced. For purposes of this determination, the definition of control is the same as previously discussed (i.e., the ability to direct the use of and obtain substantially all of the remaining benefits from the asset).

The Boards note that for a construction contract in which an entity is building on the customer’s land, the customer often controls any work in progress resulting from the entity’s performance. The Boards said they believe the customer's control over the asset as it is being created or enhanced indicates that the entity’s performance transfers goods or services to a customer over time.\(^1\)

8.1.3 Asset with no alternative use and right to payment

The Boards acknowledged that the application of the first two criteria could be challenging in certain circumstances.\(^2\) For example, a contractor may construct an asset, but only transfer title to the customer upon completion. Alternatively, an entity may provide services that result in a tangible deliverable (e.g., drawings, site plans, technical specifications) in the latter part of a contract. As a result, the third criterion (mentioned above) was added whereby, if both of the following requirements are met, entities must recognise revenue for a performance obligation over time:

- The entity’s performance does not create an asset with alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

Alternative use

An asset created by an entity has no alternative use if the entity is either restricted contractually or practically from readily directing the asset for another use (e.g., selling to a different customer). An entity has to make this assessment at contract inception and does not update its assessment unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

The Boards specified that a contractual restriction on an entity’s ability to direct an asset for another use must be substantive (i.e., a buyer could enforce its rights to the promised asset if the entity sought to sell the unit to a different buyer). In contrast, a contractual restriction may not be substantive if the entity could instead sell a different asset to the buyer without breaching the contract or incurring significant costs.

Furthermore, the Boards believe a practical limitation exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss may arise when significant costs are incurred to redesign or modify an asset or when the asset is sold at a significantly reduced price.

A contractor may be able to determine that an asset has no alternative use because its characteristics (e.g., location, design, technical specifications, materials) would generally result in a contractual and/or practical limitation to redirect its use to another buyer. In addition, an E&C entity that provides architectural or design services may conclude that drawings and plans prepared for a specific project have no alternative use.

\(^{19}\) IFRS 15.BC129.
\(^{20}\) IFRS 15.BC132.
Enforceable right to payment for performance completed to date

An entity has an enforceable right to payment for performance completed to date if, at any time during the contract term, the entity would be entitled to an amount that at least compensates it for work already performed. This right to payment must be present, even if the buyer can terminate the contract for reasons other than the entity’s failure to perform as promised.

To satisfy this criterion, the amount to which an entity is entitled must approximate the selling price of the goods or services transferred to date, including a reasonable profit margin. Compensation for a reasonable profit margin does not have to equal the profit margin expected for complete fulfilment of the contract, but it must at least reflect either of the following:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity’s performance under the contract before termination by the customer (or another party)
- A reasonable return on the entity’s cost of capital for similar contracts (or the entity’s typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts

Entities are required to consider any laws, legislation or legal precedent that could supplement or override contractual terms. In addition, the standard clarifies that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. For example, progress billings collected from a customer may not reflect a reasonable profit margin on work completed to date. The entity has to examine information that may contradict the payment schedule and may represent the entity’s actual right to payment for performance completed to date (e.g., an entity’s legal right to continue to perform and enforce payment by the buyer if a contract is terminated without cause).

The standard provides application guidance in this area. It describes a situation in which a customer has a right to terminate the contract only at certain times during the life of the contract or where the customer does not have the right to terminate the contract. If a customer seeks to terminate a contract without having a right to do so (e.g., by not performing its obligations under the contract), the entity may be entitled under the contract or relevant legislation to continue to transfer the promised goods and services to the customer and, in return, require the customer to pay the consideration promised in exchange for those promised goods or services. In such circumstances, an entity has an enforceable right to payment for performance completed to date because the entity has a right to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).21

It may be difficult to demonstrate whether a real estate developer meets this criterion in practice.

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21 IFRS 15.B11
E&C entities that provide design or engineering services may consider the following example from the standard when assessing these criteria:

**Extract from IFRS 15**

**Example 14 — Assessing Alternative Use and Right to Payment (IFRS 15.IE69-IE72)**

An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 per cent margin. The 15 per cent margin approximates the profit margin that the entity earns from similar contracts.

The entity considers the criterion in paragraph 35(a) of IFRS 15 and the requirements in paragraphs B3 and B4 of IFRS 15 to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially re-perform the work that the entity had completed to date, because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 35(a) of IFRS 15 is not met.

However, the entity's performance obligation meets the criterion in paragraph 35(c) of IFRS 15 and is a performance obligation satisfied over time because of both of the following factors:

(a) in accordance with paragraphs 36 and B6-B8 of IFRS 15, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.

(b) in accordance with paragraphs 37 and B9-B13 of IFRS 15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

Consequently, the entity recognises revenue over time by measuring the progress towards complete satisfaction of the performance obligation in accordance with paragraphs 39-45 and B14-B19 of IFRS 15.
How we see it

For many construction-type contracts, it is likely that E&C entities will determine that control of many goods or services is transferred over time. However, E&C entities will be required to understand all contract terms related to control and legal ownership of work in progress, as well as whether the asset has no alternative use and the entity has a right to payment for performance completed to date, when determining whether their construction-type contracts meet the criteria to recognise revenue over time.

8.1.4 Measuring progress

When a performance obligation is satisfied over time, the standard provides two types of methods for measuring progress under the contract: input methods or output methods. The standard requires an entity to select a single measurement method for the relevant performance obligations that best depicts the entity’s performance in transferring goods or services and it does not allow a change of method. That is, a performance obligation must be accounted for under the method the entity selects (i.e., either an input or output method) until it has been fully satisfied.

Input methods recognise revenue “on the basis of the entity’s efforts or inputs to satisfy the performance obligation …relative to the total expected inputs to the satisfaction of that performance obligation”. The standard includes resources consumed, labour hours expended, costs incurred and time elapsed as possible input methods. The standard also notes it may be appropriate to recognise evenly expended inputs on a straight-line basis.

Output methods recognise revenue “on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract”. Measurements of output may include surveys of performance completed to date, appraisals of results achieved, milestones reached and time elapsed.

When an entity applies an output method, the standard includes a practical expedient for an entity that has a right to payment from a customer in an amount that corresponds directly with the value of the entity’s performance completed-to-date (e.g., a service contract in which an entity bills a fixed amount for each hour of service provided). This practical expedient allows an entity to recognise revenue in the amount for which it has the right to invoice.

The standard does not say which method (input or output) is preferable, but it says that entities are required to use careful judgement in evaluating the advantages and disadvantages of each method and consider both the nature of the promised goods and services and the entity’s performance. The Boards also said that the selected method is required to be applied to similar arrangements in similar circumstances.

22 IFRS 15.B18.
23 IFRS 15.B15.
24 IFRS 15.BC161.
While input methods (e.g., cost incurred), may be appropriate measures of progress, similar to the current requirements under IAS 11, all E&C entities will need to carefully evaluate the principles of IFRS 15 to determine whether the pattern of revenue recognition from construction arrangements will be affected. The Boards decided that, if an entity does not have a reasonable basis to measure its progress, too much uncertainty would exist. Therefore, revenue is not recognised until progress can be measured. However, if an entity cannot reasonably measure its progress, but expects to recover costs incurred toward satisfaction of the performance obligation (i.e., a loss will not be incurred), IFRS 15 requires revenue to be recognised to the extent that costs are incurred until the entity is able to reasonably measure its progress. These requirements are consistent with IAS 11, which allows for zero-margin revenue recognition when a final outcome cannot be estimated, but an entity is assured that no loss will be incurred.25

Units of delivery

E&C entities should note that the Boards indicated a units-of-delivery or units-of-production method may not be appropriate if the contract provides both design and production services. This is because each item produced may not transfer an equal amount of value to the customer. That is, the items produced earlier likely have a higher value than the ones produced later. However, the Boards noted that units of delivery may be an appropriate method for certain long-term manufacturing contracts of standard items that individually transfer an equal amount of value to the customer.26

In addition, the standard states that “output methods based on units produced or units delivered would not faithfully depict an entity’s performance in satisfying a performance obligation if, at the end of the reporting period, the entity’s performance has produced work in progress or finished goods controlled by the customer that are not included in the measurement of output”.27

Uninstalled materials

E&C entities applying an input method that uses costs incurred to measure progress towards completion may find that certain costs incurred do not contribute to the entity’s progress in satisfying the performance obligation. For example, entities would exclude the costs that may be related to wasted materials or other significant inefficiencies. Furthermore, when uninstalled materials meet all of the four criteria in the extract below, an entity will recognise revenue in an amount equal to the cost of the goods (i.e., at zero margin) and adjust its measure of progress to exclude the costs from the costs incurred and from the transaction price (i.e., from both the numerator and the denominator of its percentage complete calculation).

25 IAS 11.32.
26 IFRS 15.BC165.
27 IFRS 15.B15.
Extract from IFRS 15

B19. A shortcoming of input methods is that there may not be a direct relationship between an entity’s inputs and the transfer of control of goods or services to a customer. Therefore, an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity’s performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

(a) When a cost incurred does not contribute to an entity’s progress in satisfying the performance obligation. For example, an entity would not recognise revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity’s performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labour or other resources that were incurred to satisfy the performance obligation).

(b) When a cost incurred is not proportionate to the entity’s progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity’s performance may be to adjust the input method to recognise revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity’s performance might be to recognise revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

(i) the good is not distinct;

(ii) the customer is expected to obtain control of the good significantly before receiving services related to the good;

(iii) the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and

(iv) the entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs B34–B38).
The standard provides the following illustration for considering uninstalled materials when applying an input method that uses costs incurred to measure progress towards completion:

### Extract from IFRS 15

**Example 19 — Uninstalled Materials (IFRS 15.IE95-IE100)**

In November 20X2, an entity contracts with a customer to refurbish a 3-storey building and install new elevators for total consideration of CU5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are CU4 million, including CU1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs B34–B38 of IFRS 15, because it obtains control of the elevators before they are transferred to the customer.

<table>
<thead>
<tr>
<th>CU</th>
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<tbody>
<tr>
<td><strong>Transaction price</strong></td>
<td>5,000,000</td>
</tr>
<tr>
<td><strong>Expected costs</strong></td>
<td></td>
</tr>
<tr>
<td>Elevators</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Other costs</td>
<td>2,500,000</td>
</tr>
<tr>
<td><strong>Total expected costs</strong></td>
<td>4,000,000</td>
</tr>
</tbody>
</table>

The entity uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity’s progress in satisfying the performance obligation, in accordance with paragraph B19 of IFRS 15. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators (CU1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation (CU4 million). The entity is not involved in designing or manufacturing the elevators.

The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity’s performance. Consequently, in accordance with paragraph B19 of IFRS 15, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognises revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (ie at a zero margin).

As of 31 December 20X2 the entity observes that:

(a) other costs incurred (excluding elevators) are CU500,000; and
(b) performance is 20 per cent complete (ie CU500,000 ÷ CU2,500,000).

Consequently, at 31 December 20X2, the entity recognises the following:

<table>
<thead>
<tr>
<th>CU</th>
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<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>2,200,000</td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td>200,000</td>
</tr>
</tbody>
</table>

(a) Revenue recognised is calculated as (20 per cent × CU3,500,000) + CU1,500,000. (CU3,500,000 is CU5,000,000 transaction price – CU1,500,000 costs of elevators.)

(b) Cost of goods sold is CU500,000 of costs incurred + CU1,500,000 costs of elevators.
8.2 Control transferred at a point in time

For performance obligations for which control is not transferred over time, control is transferred at a point in time. In many situations, the determination of when that point in time occurs is relatively straightforward. However, in other circumstances, this determination is more complex.

IFRS 15 provides the following indicators for entities to consider in determining when control of a promised asset has been transferred:

- 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
- The customer has accepted the asset

None of these indicators are meant to be individually determinative. The Boards also clarified that the indicators are not meant to be a checklist and not all of them must be present for an entity to determine that the customer has gained control. An entity is required to consider all relevant facts and circumstances to determine whether control has transferred.

9. Other measurement and recognition topics

IFRS 15 specifies how to account for contract costs, contract assets and liabilities, and warranties. Also the requirements in IAS 37 Provisions, Contingent Liabilities and Contingent Assets for onerous contracts apply to all contracts in the scope of IFRS 15. This may result in changes for certain E&C entities.

9.1 Contract costs

IFRS 15 also specifies the accounting treatment for certain costs an entity incurs in obtaining and fulfilling a contract to provide goods and services to customers for both contracts obtained and contracts under negotiation. However, the requirements in IFRS 15 only apply if another standard does not apply to those costs (e.g., IAS 2 Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets).

Under IFRS 15, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognised as an asset if the entity expects to recover them. This can mean direct recovery (i.e., through reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits immediate expense recognition for a contract acquisition cost when the asset that would have resulted from capitalising such a cost would have had an amortisation period of one year or less.

The standard cites sales commissions that are directly related to sales achieved as an example of an incremental cost that may require capitalisation. In contrast, some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely will not meet the criteria for capitalisation because they are not directly related to obtaining a contract.
IFRS 15 also specifies how to account for costs incurred in fulfilling a contract (i.e., costs that relate directly to a contract, such as materials and labour) that are not in the scope of another standard. Costs to fulfil a contract that are accounted for under IFRS 15 are divided into two categories: (1) those that give rise to an asset; and (2) those that are expensed as incurred. Entities will recognise an asset when costs incurred to fulfil a contract meet all of the following criteria:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.
- The costs are expected to be recovered.

When determining whether costs may be eligible for capitalisation, an entity must consider its specific facts and circumstances. The standard provides examples of costs that may be eligible for capitalisation (i.e., costs that relate directly to the contract). Such costs include:

- Direct labour (e.g., salaries and wages of employees who provide the promised services directly to the customer)
- Direct materials (e.g., supplies used in providing the promised services to a customer)
- Allocations of costs that relate directly to the contract or to contract activities (e.g., costs of contract management and supervision, insurance, depreciation of tools and equipment used in fulfilling the contract)
- Costs that are explicitly chargeable to the customer under the contract
- Other costs that are only incurred because an entity entered into the contract (e.g., payments to subcontractors)

For costs to meet the ‘expected to be recovered’ criterion, they need to be either explicitly reimbursable under the contract or reflected through the pricing of the contract and recoverable through the margin.

How we see it

The Boards noted that only costs that meet the definition of an asset (i.e., meet the criteria described above) are eligible for capitalisation. Entities are precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract.

28 IFRS 15.BC308.
9.2 Onerous contracts

The requirements in IAS 37 for onerous contracts apply to all contracts in the scope of IFRS 15. IFRS 15 states that entities that are required to recognise a liability for expected losses on contracts under IAS 37 will continue to be required to do so. IAS 37 requires the following in respect of onerous contracts:

**Extract from IAS 37**

66. If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

67. Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

68. This Standard 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 under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

69. Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see IAS 36).

We note that the wording of the requirements in IAS 37 do not exactly mirror the equivalent requirements in IAS 11 which states, “when it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately”. While these standards use different terminology, the timing of recognition of an onerous contract provision under IAS 37 and the related expense will likely be consistent with when an expected loss would be recognised under IAS 11 currently. However, it is not yet clear whether entities would need to change the way such provisions are measured.

9.3 Contract assets and contract liabilities

Today, IAS 11 requires entities to record assets for unbilled accounts receivable when revenue is recognised but not billed. Once the invoice is submitted to the customer, the unbilled receivable is reclassified as a billed accounts receivable. Similarly, billings in excess of costs are generally recognised as liabilities.

IFRS 15 is based on the notion that a contract asset or contract liability is generated when either party to a contract performs. An entity is required to present these contract assets or contract liabilities in the statement of financial position. Under IFRS 15, entities are not required to use the terms ‘contract asset’ or ‘contract liability’, but must disclose sufficient information so that users of the financial statements can clearly distinguish between an unconditional right to consideration (a receivable) and a conditional right to receive consideration (a contract asset).

29 IAS 11.33.
Under the standard, when an entity satisfies a performance obligation by delivering the promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. Once the entity has an unconditional right to receive the consideration from the customer, the right represents a receivable from the customer that would be classified separately from contract assets. This occurs when there are no further performance obligations required to be satisfied before the entity has the right to collect the customer’s consideration. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due. Therefore, unlike the requirements in IAS 11, the timing of the reclassification of a balance from a contract asset to an accounts receivable balance may differ from the timing of the invoicing of the receivable. For example, a contractor could record a receivable (rather than a contract asset) for revenue related to construction completed to date prior to submitting a progress bill in accordance with the billing schedule in the contract.

When the customer performs first—for example, by prepaying its promised consideration—the entity has a contract liability. This is consistent with today’s requirements for billings in excess of costs in IAS 11.

Receivables and contract assets are subject to an impairment assessment in accordance with IFRS 9 or IAS 39. In addition, if upon initial measurement, there is a difference between the measurement of the receivable under IFRS 9 or IAS 39 and the corresponding amount of revenue, that difference will be presented as an expense (e.g., as an impairment loss). Impairment losses resulting from contracts with customers are presented separately from losses on other contracts.

9.4 Warranties

Warranties are commonly included in contracts to sell goods or services, whether explicitly stated or implied based on the entity’s customary business practices. The standard identifies two types of warranties:

- Warranties that promise the customer that the delivered product is as specified in the contract are called ‘assurance-type warranties’. The Boards concluded that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee. For example, E&C entities often provide various warranties against construction defects and the failure of certain operating systems for a period of time. Under the standard, the estimated cost of satisfying these warranties is accrued in accordance with the current requirements in IAS 37.

- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract are called ‘service-type warranties’. If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity will allocate a portion of the transaction price to the warranty based on the estimated stand-alone selling price of the warranty. The entity will recognise revenue allocated to the warranty over the period the warranty service is provided. Service-type warranties may be infrequent in the E&C industry.
10. Disclosures

The stated objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, qualitative and quantitative disclosures are required for: contracts with customers; significant judgements and changes in judgements, made in applying IFRS 15 to those contracts; and any assets recognised from the costs to obtain or fulfil a contract with a customer. These requirements are explored further in the following sections.

10.1 Contracts with customers

10.1.1 Disaggregation of revenue

The disclosure requirements include revenue disaggregated into categories to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors. While the standard does not specify precisely how revenue is required to be disaggregated, the application guidance suggests categories, as follows:

- Type of good or service (e.g., major product lines);
- Geographical region (e.g., country or region);
- Market or type of customer (e.g., government and non-government customers);
- Type of contract (e.g., fixed price and time-and-materials contracts);
- Contract duration (e.g., short-term and long-term contracts);
- Timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time); and
- Sales channels (e.g., goods sold directly to customers and goods sold through intermediaries).

E&C entities will need to consider their specific facts and circumstances, as well as how they disaggregate revenue in other communications (e.g., press releases, other public filings) to determine how best to meet this disclosure requirement.

10.1.2 Contract balances

The disclosures related to contract balances are extensive and intended to enable users to understand the relationship between the revenue recognised and changes in overall balances of total contract assets and liabilities in a particular reporting period.

For example, disclosures required include revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period; revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (e.g., changes in transaction price; an explanation of the timing of satisfaction of performance obligations compared to the typical timing of payment; and an explanation of the significant changes in the contract asset and liability balances during the period (e.g., due to business combinations, cumulative catch-up adjustments, impairment).

30 IFRS 15.110.
10.1.3 Transaction price allocated to remaining performance obligations
Entities must disclose the aggregate amount of the transaction price allocated to the remaining performance obligations and an explanation of when they expect to recognise the amounts through both quantitative and qualitative disclosures.

10.2 Significant judgements
The standard specifically requires disclosure of significant judgements and estimates made in determining the transaction price; allocating the transaction price to performance obligations; and determining when performance obligations are satisfied.

For E&C entities that recognise revenue at a point in time, but conclude that this occurs in advance of passing of legal title, disclosure will be required of the significant judgements made in evaluating at what point in time the customer obtains control of an asset.

10.3 Assets recognised from the costs to obtain or fulfil a contract
The standard requires disclosure of information about assets recognised from the costs to obtain or fulfil a contract. These disclosures are intended to explain the types of costs recognised as assets (e.g., sales commissions) and how those assets are subsequently amortised or impaired.

10.4 Practical expedients
There are several practical expedients within the standard that may lead to financial results that differ from a full application of the standard. As such, entities are required to disclose where these expedients have been used. For example, if an entity elects to use the practical expedient associated with determining whether a significant financing component exists, the entity must disclose those facts.

How we see it
IFRS 15 significantly increases the volume of disclosures required in entities’ financial statements, particularly for annual financial statements.

For some E&C entities there may be no change in the timing of revenue recognition under IFRS 15, but the new disclosure requirements may, nonetheless, require significant additional effort (e.g., changes to systems, internal controls, policies and procedures) to collect and disclose the required information. In light of the expanded disclosure requirements and the potential need for new systems to capture the data needed for these disclosures, entities may wish to prioritise this portion of their implementation plans.
11. Next steps

We encourage E&C entities to gain an understanding of the new standard and evaluate how it will affect their specific revenue recognition policies and practices.

E&C entities should consider whether they will need to make any changes to their accounting policies, accounting systems or internal controls over financial reporting.

E&C entities also may wish to monitor the discussions of the Boards, the TRG and the industry task forces formed by the American Institute of Certified Public Accountants (AICPA) as they discuss interpretations and application of the new standard to common transactions (noting that any views produced by the TRG or AICPA are non-authoritative).
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