EFRAG

European Financial Reporting Advisory Group

EUROPEAN FIELD-TEST OF THE IASB'S EXPOSURE DRAFT REVENUE FROM CONTRACTS WITH CUSTOMERS

CONSTRUCTION (REAL-ESTATE)

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Preparation of the feedback statement

Summary of the input received from real-estate construction companies

This note summarises the input received from European real-estate construction companies' field-tests of the IASB's Exposure Draft *Revenue from Contracts with Customers* ('the ED'), published in November 2011.

This feedback statement has been prepared for the convenience of European constituents by EFRAG's secretariat. It has been reviewed by participants in the field-test.

About the field-test

Focus on application issues, the effect on financial statements and cost of applying the proposal

The purpose of the European field-test of the ED was to:

- identify potential implementation and application difficulties;
- assess the potential impact of the proposals on financial statements;
- estimate the effort required to implement and apply the proposals.

The field-test did not assess whether the requirements proposed in the ED represent an improvement to current accounting practice. The field-test only provides some input for such an assessment.

The participants in the field-test were asked to select some of their contracts, apply the requirements proposed in the ED on these contracts, and report their findings at workshops.

All European entities expressing a wish to participate in the field-test were invited to participate. The entities participating in the field-test do therefore not constitute a representative sample of the entities that will be affected by the proposals. Similarly, the assessed directions and changes in elements of financial position and performance only reflect the outcome of the selected contracts based on the accounting practice currently chosen for those contracts.

Participating companies

Four companies participated in the field test

The following real-estate constructions companies participated in the field-test (participants):

- JM AB
- NCC AB
- Peab AB
- Skanska AB

The results of each company's tests were presented at a workshop hosted by the Swedish Financial Reporting Board on 12 January 2012 in Stockholm.

Results of the field-test – implementation and application

A member of the IASB staff was present at the workshop and provided explanations on many of the issues raised by participants. The issues listed below reflect implementation and application problems that were identified by participants before the additional explanations were provided.

Guidance on how to identify separate performance obligations

Participants were in some instances uncertain about whether a good or service was distinct

Paragraphs 28 to 30 of the ED include guidance on how to identify separate performance obligations. Paragraph 28 provides criteria for when a good or service is distinct.

Paragraph 29 specifies that a good or service in a bundle of promised goods or services is not distinct and, therefore, the entity shall account for the bundle as a single performance obligation if both of the following criteria are met:

- the goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
- the bundle of goods or services is significantly modified or customised to fulfil the contract.

Participants considered the criteria included in the ED clearer than those included in the 2010 ED. However, participants were in some cases unsure about the practical consequences of the proposals of the ED. In particular:

- Participants were unsure about when goods or services should be considered 'highly interrelated' (paragraph 29 of the ED).

For example, a participant considered it unclear whether a developer should account for the transfer of the developer´s land under a related construction contract as a distinct good, or whether the developer was providing a significant service of integrating the constructions with the land.

- Participants were uncertain about whether a warranty required by law for a good delivered to the customer by an entity could be considered ‘highly interrelated’ with the good when the warranty was issued by an insurance company on the entity’s behalf. If the warranty would not be considered ‘highly interrelated’, the result might be that the warranty should be accounted for as a separate performance obligation.

Performance obligations satisfied at a point in time

Participants found it difficult to determine the point in time at which a performance obligation would be satisfied

Paragraph 37 of the ED includes indicators of when an entity transfers control of a promised asset.

Based on the ED, participants considered it difficult to determine at what point in time a performance obligation would be satisfied in the case of the transfer of real-estate (in its current state). For contracts completed in Sweden, participants assessed that Swedish civil law considered transfer of real estate as a gradual transfer of rights and duties between the date of agreement and the subsequent payment which resulted in the title transfer. In addition, participants regarded the land registration certificate as a confirmation of the transfer in civil law terms only. It was noted that contract conditions varied, and this could affect the point in time of revenue recognition. However, participants assessed that when no specific conditions were included in the contract, the ED could result in revenue being recognised when the contract was agreed.

Participants considered whether it would have an impact on the outcome if the transaction would take place by means of the sale of shares of a company containing no other assets than the real-estate in question instead of the transfer of the property asset itself. Participants expected that there would be no difference.

Measuring progress towards complete satisfaction of a performance obligation

Participants found it difficult to assess whether a cost overrun would be caused by wasted

Paragraph 45 of the ED states that when using an input method, an entity shall exclude the effects of any inputs that do not depict the transfer of control of goods or services to the customer (for example, the costs of wasted materials, labour or other resources *material or inadequate budgets*

to fulfil the contract that were not reflected in the price of the contract).

Participants noted that the transaction price for a construction would include a buffer for costs not specified in the budget. Participants therefore considered it difficult to determine whether a cost overrun on the specified part of the project related to materials and labour would represent wasted materials or inadequate budgeting and resulting changes in estimates.

Time value of money

Requirements on how and when to account for the time value of money were not considered operational

According to the ED, the transaction price shall be adjusted to reflect the time value of money if a contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognise revenue at an amount that reflects what the cash selling price would have been at the date control is transferred. Paragraph 61 of the ED states that:

'[t]o adjust the promised amount of consideration to reflect the time value of money, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception.[...].'

Participants in the field-test considered the requirements on how and when to account for the time value of money clear but not operational as:

- Determining the discount rate in accordance with the requirements would involve subjective judgements. Accordingly, there would be a significant range of discount rates that people would consider appropriate.
- Accounting for the time value of money in accordance with the proposals would require an entity to be able to reasonably estimate when it would satisfy the related performance obligations. This would not always be possible.

Results of the field-test – impact on financial statements

The test identified the following potential impact on the financial statements:

The ED would change how some companies account for

- The proposal would affect how some companies account for the time value of money. Currently, some companies assess *the time value of money*

whether a contract includes a significant financing component by comparing the pattern of cash inflows (from the customer) and the cash outflows (to the suppliers). If these patterns are similar, some field-test participants consider that the contract does not include a significant financing component. The ED requires an entity to compare the pattern of cash inflows to the pattern of revenue recognition. Accordingly, the ED could result in a higher or lower amount of revenue being recognised with a correspondingly higher or lower amount of finance cost.

The ED would change the pattern of revenue recognition for some developers

- Some developers would be affected by the proposal. In particular, those that are involved in all phases of a project (i.e. purchasing land, project development and construction). The developer procures both land and construction when a contract with the customer is agreed. Currently the transfer of the land and the construction are accounted for as one performance obligation by some developers. When measuring progress towards complete satisfaction of the performance obligation by reference to costs, the same profit margin will therefore be attached to the sale of the land and the construction work. If the ED would require the piece of land to be considered as a distinct good, accordingly, the profitability reported when transferring the land to the customer would be different than the profitability reported when performing the construction.

The ED would change how companies account for costs related to unanticipated waste

- When a performance obligation is satisfied over time, an entity may measure the progress towards complete satisfaction of a performance obligation by considering the costs incurred to date. When measuring progress towards complete satisfaction of a performance obligation applying an input method, paragraph 45 of the ED explains:

  '[...] when using an input method, an entity shall exclude the effects of any inputs that do not depict the transfer of control of goods or services to the customer (for example, the costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract).'

Paragraph 45 of the ED is considered by some companies to restrict the costs to be taken into consideration when determining the degree of completion. Currently, a lower profit margin resulting from higher than expected cost would affect the whole remaining contract term. The ED would require higher than expected cost resulting from unanticipated waste to be excluded when determining the degree of completion on a cost-to-cost basis. The effect would be that the additional cost would affect profit and loss immediately.

Results of the field-test – Costs

The test identified the following potential costs associated with applying the ED:

More detail knowledge of individual contracts needed in order to make judgements regarding unbundling into distinct goods and services will be needed

- Judgement would be required to assess whether a contract should be unbundled into distinct goods and/or services. As mentioned above, the ED states that an entity shall account for a bundle of goods or services as a single performance obligation if the goods or services are highly interrelated and significantly modified or customised to fulfil the contract. Participants in the field-test assessed that determining whether a bundle of goods or services is highly interrelated would require the accounting department of a company to have more detailed knowledge of the individual contracts than what is necessary today.

Need for more advanced systems when unexpected waste cannot be included when measuring progress on a cost-to-cost basis

- When a performance obligation is satisfied over time, an entity may measure the progress towards complete satisfaction of a performance obligation by considering the costs incurred to date. As mentioned above, participants in the field-test considered that the ED restricts the costs to be taken into consideration when determining the percentage of completion by means of a cost-to-cost approach compared with current practice following the requirements in IAS 11 *Construction Contracts*. This could mean that entities will have to keep two sets of cost accounts for projects (where only one is needed today): one to keep track of the costs related to the project and another to be used when determining the degree of completion of a project.

System changes required to be able to provide disclosures

- The ED requires more detailed disclosures than currently. Among other things, it requires a reconciliation of contract balances. Participants in the field-test assessed that their reporting systems and environment needed additional extensions in order to comply with the proposed requirements. Among other things, participants noted that system enhancements were needed in order to collect information about revenue from allocating changes in the transaction price to performance obligations satisfied in previous reporting periods (paragraph 117(a)(ii) of the ED). These disclosure requirements are narrower than those (currently) required by IAS 8 *Accounting Policies, Changes in Accounting Estimates* *and Errors* in relation to changes in estimates. At the same time participants considered that the materiality assessment could be different for the two sets of disclosures so that it is more likely that an entity has to provide the disclosures required by paragraph 117(a)(ii) of the ED than about changes in estimates under IAS 8.