STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Costs to Fulfil a Contract (IFRS 15)**
Paper topic	Initial Consideration

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about whether, applying IFRS 15 *Revenue from Contracts with Customers*, an entity recognises as an asset (or as an expense) costs incurred to fulfil a performance obligation as the entity satisfies that performance obligation over time.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information (paragraphs 5–6);

   (b) staff analysis (paragraphs 7–13); and

   (c) staff recommendation (paragraph 14).

4. There are two appendices to this paper:

(a) Appendix A—Proposed wording of the tentative agenda decision; and

(b) Appendix B—Submission.

Background information

5. In the fact pattern described in the submission, an entity constructs a building. The entity enters into a contract with a customer to transfer the building to the customer. The entity:

(a) has determined that there is one performance obligation in the contract—the promise to transfer the building to the customer;

(b) transfers control of the building over time (as it is being constructed) and, therefore, satisfies the performance obligation and recognises revenue over time applying paragraph 35(c) of IFRS 15;

(c) measures progress towards complete satisfaction of the performance obligation using an output method applying paragraph 41 of IFRS 15; and

(d) incurs costs to construct the building that is transferred to the customer over time—those costs relate to past performance in partially satisfying the performance obligation.

6. The submission asks whether, applying paragraph 95 of IFRS 15, the entity recognises an asset for some of the costs incurred for work done in constructing the building that is transferring to the customer as the building is constructed. In particular, the submitter highlights paragraph 95(b) of IFRS 15, which states:

> 95 If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (for example, IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*), an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria: …

> (b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; …

Staff analysis and conclusion

7. Paragraph 98(c) of IFRS 15 states:

> 98 An entity shall recognise the following costs as expenses when incurred: …
>
> (c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); …

8. In the fact pattern described in the submission, the costs to construct the building are costs that relate to satisfied (or partially satisfied) performance obligations as described in paragraph 98(c). Those costs relate to construction work done on the part-constructed building, which has been transferred to the customer. The costs therefore relate to the entity's past performance. The entity transfers control of the building over time as the building is being constructed and, thus, has partially satisfied the performance obligation at the reporting date. Accordingly, applying paragraph 98(c), in the fact pattern described in the submission the entity recognises those costs as expenses when incurred.

9. In satisfying the performance obligation and recognising revenue over time, the entity has transferred control of the part-constructed building to the customer and therefore does not have this resource. The entity may have a resource (eg a contract asset or receivable) that arises from its past performance under the contract—however, the entity will not use that resource in satisfying (or in continuing to satisfy) the performance obligation in the future. Accordingly, the costs incurred by the entity do not meet the criterion in paragraph 95(b) of IFRS 15 (reproduced above in paragraph 6 of this paper).

10. We note that paragraph BC308 of IFRS 15 explains that the requirements in paragraph 95 of IFRS 15 were designed to ensure that an entity recognises costs as an

asset only when they meet the definition of an asset, and preclude the deferral of costs merely to normalise profit margins throughout a contract. Paragraph BC308 states:

> BC308 IFRS 15 clarifies that only costs that give rise to resources that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets. Those requirements ensure that only costs that meet the definition of an asset are recognised as such and that an entity is precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract. To provide a clear objective for recognising and measuring an asset arising from the costs to fulfil a contract, the boards decided that only costs that relate directly to a contract should be included in the cost of the asset.

11. The analysis in paragraphs 7–10 of this paper is consistent with 'view 1' in the submission (see Appendix B to this paper). We contacted the submitter to ask about what it describes as 'view 2' in the submission (ie an entity recognises as an asset some of the costs of constructing the building). On asking specifically for the following information, the submitter was unable to:

    (a) identify requirements in IFRS Standards that support 'view 2'; or

    (b) provide any evidence that entities apply 'view 2' in practice.

12. Accordingly, we have not analysed this submission further.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IFRS 15 outlined in paragraphs 7–10 of this paper?

Should the Committee add this matter to its standard-setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

13. Based on our analysis, we think the requirements in existing IFRS Standards provide an adequate basis for an entity to determine whether to recognise as an asset (or as an expense) the costs incurred in satisfying a performance obligation over time in the fact pattern described in the submission.

Staff recommendation

14. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 13 of this paper), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that explains how an entity recognises costs incurred in satisfying a performance obligation over time in the fact pattern described in the submission.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

[1] Paragraph 5.16(b) of the *Due Process Handbook*.

Appendix A—Proposed wording of the tentative agenda decision

Costs to Fulfil a Contract (IFRS 15 *Revenue from Contracts with Customers*)

The Committee received a request about the recognition of costs incurred to fulfil a contract as an entity satisfies a performance obligation in the contract over time. In the fact pattern described in the request, the entity transfers control of a good over time and, therefore, satisfies a performance obligation and recognises revenue over time applying paragraph 35 of IFRS 15. The entity incurs costs in constructing the good. At the reporting date, the costs incurred relate to construction work performed on the good that is transferring to the customer as the good is being constructed.

Paragraph 98(c) of IFRS 15 requires an entity to recognise as expenses when incurred costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in a contract—ie costs that relate to past performance.

The Committee observed that the costs of construction described in the request are costs that relate to the partially satisfied performance obligation in the contract—ie they are costs that relate to the entity's past performance. Those costs do not meet the criteria in paragraph 95 of IFRS 15 to be recognised as an asset.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine how to recognise costs incurred in fulfilling a contract in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—Submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

IFRS Interpretations Committee Potential Agenda Item Request

[We] would like to request for the IFRS Interpretations Committee (IFRIC) to address the following issue that relates to the interpretation of paragraph 95(b) of IFRS 15 *Revenue from Contracts with Customers*:

…an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

a) …
b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
c) …

BC308 states that only costs that give rise to <u>resources</u> that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets. This ensures that only costs that meet the definition of an asset are recognised as such and that an entity is precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract.

Paragraph 98(c) of IFRS 15 states that an entity shall recognise costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e. costs that relate to past performance) as expenses when incurred.

Divergent views under IFRS have emerged on whether the costs incurred for construction generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

1. <u>Subject</u>

Costs to fulfil a contract – capitalisation of costs incurred for construction of a building to work in-progress when the contract with the customer is a single performance obligation satisfied over time in accordance with paragraph 35(c) of IFRS 15.

2. <u>Background</u>

This paper is written in the context of a property developer constructing a building on its own land. Construction of a building usually straddles over a number of years and encompasses various inter-related components such as foundation (substructure), walls and columns, floor structures, roof structures, doors and windows etc (superstructure).

The above components are not separately identifiable or distinct under IFRS 15.27, and accordingly, the contract with the customer is a single performance obligation.

In practice, the main construction contractor includes in its construction contract a "quotation booklet" listing hundreds of items with individual price components. However, in substance, the main construction contractor regards the contract with the customer as a single performance obligation. For example, the foundation work may have been completed with a high profit (higher than the average margin implicit in the total contract price) or at a loss (while the entire contract is profitable) but the main contractor would not recognise the profit or loss at that point based on the foundation work completed. However, a subcontractor for the foundation work would recognise the profit or loss on completion of the foundation contract.

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 [IFRS 15.35(c)]. Hence, revenue is recognised over time.

The appropriate method for measuring progress has been determined to be an output method [IFRS 15.41].

3. Issue

The issue relates to the interpretation of paragraph 95(b) of IFRS 15:

… an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

a) …
b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
c) …

BC308 states that only costs that give rise to resources that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets. This ensures that only costs that meet the definition of an asset are recognised as such and that an entity is precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract.

Paragraph 98(c) of IFRS 15 states that an entity shall recognise costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e. costs that relate to past performance) as expenses when incurred.

Divergent views under IFRS have emerged on whether the costs incurred for construction generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

Illustration

The reporting entity has been contracted to build a house (on its own land) for a customer. The construction takes 3 years to complete.

This contract is a single performance obligation satisfied over time in accordance with IFRS 15.35(c).

	Components	Revenue allocated using the output method	Cost of the component	Margin
1	Foundation	$2,100,000	$2,000,000	4.8%
2	Walls and columns	$1,200,000	$1,000,000	16.7%
3	Windows / doors	$800,000	$500,000	37.5%
4	Roof	$900,000	$500,000	44.4%
		$5,000,000	$4,000,000	20%

Scenario

Assume that Component 1 (i.e. foundation) is completed at the end of the reporting period, and revenue of $2,100,000 is recognised for this component. The total cost (based on the subcontractor costs) for the component is $2,000,000.

Question: Should the $2,000,000 be partially recognised as a fulfilment costs for the other stages of the contact?

View 1 – All costs are to be expensed when incurred

Under the above scenario, the $2,000,000 will be expensed in accordance with paragraphs 95(b) and 98(c) of IFRS 15.

The costs incurred for Component 1 are not incurred to generate or enhance resources of the entity that will be used to satisfy "performance obligations in the future". Instead, the costs are incurred to satisfy a current performance obligation. Furthermore, paragraph 98(c) of IFRS 15 reiterates that costs that relate to partially satisfied performance obligations are to be expensed when incurred.

View 2 – Part of the costs incurred can be capitalised

Under the above scenario, Component 1 (i.e. foundation) is necessary for the continuing delivery of the different components (i.e. walls and columns, windows/doors, roof). Hence, some of the cost of Component 1 should be allocated to the other components that are yet to be completed. This reflects more representatively the economics of the contract as the contract involves the delivery of one performance obligation (the house) to the customer. Some of the cost incurred for Component 1 is a resource that will be used to satisfy the construction of future components. The method to allocate cost to partially completed performance obligation and future obligation may be by using the overall margin of the contract.

Reasons for the IFRIC to address the issue

a. Is the issue widespread and has, or is expected to have, a material effect on those affected?

Yes. This issue is prevalent in the construction industry (property developer constructing a building on its own land) and the divergent views will result in significantly different accounting outcome.

b. Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. The elimination of the diverse reporting methods will promote consistency in the application of IFRS 15.

c. Can the issue be resolved efficiently within the confines of IFRS Standards and the Conceptual Framework for Financial Reporting?

Yes. The issue can be resolved efficiently as it involves the interpretation of IFRS 15.95(b).

d. Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?

Yes. We believe that this issue is sufficiently narrow in scope that it can be addressed in an efficient manner.

e. Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.

We are unaware of any current or planned IASB project that will directly address this issue.