

## **IFRS 15 APPLICATION FOR ACCOUNTING OF REVENUE FROM CONSTRUCTION CONTRACTS**

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### **ABSTRACT**

*Construction, like any industry, has its own specifics, which should be taken into account when organizing the accounting work of an enterprise. In addition to material consumption, labor intensity and risks, construction is characterized by a long production cycle, which largely determines the financial and economic flows of a construction organization. It is common in the construction industry to provide a variety of services for a single customer or to related parties of a customer. A construction company, in addition to the construction services, can also be hired to provide design services, project management, consulting, supervision, engineering survey, design, installation, commissioning and other types of work. The article is devoted to the problems of IFRS 15 application for proceeds accounting under construction contracts. The article discusses the specifics of accounting organization for income and expenses in the construction industry. 5 steps of the revenue accounting model are considered, a step-by-step procedure for working with contracts to recognize revenue. The article outlines a mechanism for recognizing revenue and allocating expenses. The article notes that, despite the complexity of IFRS 15, its new application improves the accounting system for income and expenses of construction companies and solves the problem of recognizing revenue and the financial result determination in construction. Owing to the control system contained in IFRS 15, construction companies can incrementally enhance their revenue recognition accounting system and remove the customer risks related to contracts.*

**Keywords:** *Construction; distribution mechanism; expenses; international financial reporting standards; Revenues.*

## 1. INTRODUCTION

Construction can be viewed as a service consisting of many components, such as cleaning a construction site, laying a foundation, supplying, building a structure, laying pipes and wires, and so on. These works and services can be combined in one contract or divided under different sub-contracts. All this testifies to the complex nature of contracts in construction and is reflected in the industry specifics of revenue recognition and accounting.

Another feature of accounting in construction companies is that a large amount of material costs arises after economic activities. Accounting should be built in such a way that the owners of an economic entity could receive timely reliable information on costs for control purposes. An important fact is the need to determine the estimated cost of construction and installation work, which is the basis for a timely and reasonable write-off of costs and their attribution to the financial result of construction work.

Construction is usually carried out for more than one accounting period and during the entire construction a contractor bears all the costs associated with the construction contract. In this regard, the question arises about the procedure for revenue recognition until the moment a facility is built and handed over to a customer.

The purpose of this article is to outline the mechanism for the recognition of proceeds and the distribution of costs under a contract during the accounting of enterprises in the construction industry.

The degree of the problem study concerning development of financial result accounting is touched upon in the works of many Russian and foreign scholars (Krasova et al., 2018; Miroshnikova & Taskaeva, 2018; Konvisarova et al., 2020; Varkulevich & Bubnovskaya, 2020).

## 2. METHODOLOGY

During the work writing, a number of scientific methods were used, including non-formalized ones. The main ones include analysis, synthesis, comparison, assessment, generalization method, and system analysis.

### 3. RESULTS, DISCUSSION

PBU 2/2008 is devoted to the revenue recognition procedure under construction contracts, the duration of which is more than one reporting period (or the start and end dates of which fall on different reporting periods) (Alotibi, 2018).

This provision applies to work contracts, the provision of services in the field of architecture, engineering and technical design in construction and other services inextricably linked with the facility under construction, to the performance of work on the restoration of buildings, structures, ships, on their liquidation (dismantling), including related environment restoration works.

PBU 2/2008 is applicable only to long-term contracts, the terms of which cover several years (the clauses 1, 2 of PBU 2/2008), that is, this provision does not apply to the works begun and completed within one year.

According to the clause 3 of PBU 2/2008, accounting of income, expenses and financial results must be kept separately for each contract. At the same time, if several identical contracts have been concluded for the construction of one object, which actually relate to a single project with a profit rate determined as a whole under the contracts, are executed simultaneously or sequentially (continuously following one after the other), such contracts are considered as one (the clause 5 of PBU 2/2008) (Alotibi, 2018).

The amount of revenue under the contract is determined based on the cost of work at the price specified in the contract. It can be adjusted for the number of deviations, claims and incentive payments if there is confidence that such amounts will be recognized by customers or other persons specified in the contract to whom they are presented, and their amount can be reliably determined (the clause 8 and 9 of PBU 2/2008).

In turn, according to PBU 2/2008, expenses are divided into three groups (paragraphs 11 - 14 of PBU 2/2008):

- direct costs under the contract directly related to its execution;
- indirect costs, i.e., the part of the organization total expenses for the execution of contracts reasonably allocated to this contract. Distribution methods are established in the accounting policy of the organization and are applied systematically and consistently;

- other expenses, which include part of the general overhead costs for the organization management or the costs of research and development, the reimbursement of which is stipulated by the contract (Alotibi, 2018).

These contract costs are recognized in the reporting period in which they are incurred. In this case, the costs related to the work performed under the contract are accounted for as production costs, and the costs incurred in connection with the forthcoming work - as deferred costs (the clause 16 of PBU 2/2008) (Alotibi, 2018).

In addition to those listed above, there may be the costs that arise before the contract signing and are directly related to its preparation and conclusion. Among them are expenses for the development of a feasibility study, preparation of an insurance contract for the risks of construction works, etc. If they can be reliably determined and if it is probable that the contract will be signed during the reporting period in which they arise, such costs are included in contract costs. If these conditions are not met, expenses are recognized as other expenses of the period in which they were incurred (the clause 15 of PBU 2/2008) (Alotibi, 2018).

With a long production cycle, revenue can be recognized in accounting either as it is ready, or upon the contract completion as a whole (the clause 13 of PBU 9/99) (Alotibi, 2018). At the same time, the regulatory legal acts on accounting in the Russian Federation do not establish the methods for determining the readiness of work (other than the work under a construction contract), services, and products with a long production cycle. Based on the current provisions of the legislation, an organization must develop such a method independently, applying, first of all, IFRS and in particular: - IFRS 15 “Revenue from the contracts with customers” (Alotibi, 2018).

With the introduction of IFRS 15, construction contracts are accounted for in the same way as any contracts with customers, except for those expressly named in the standard (Alotibi, 2018). A feature of IFRS 15 is the presence of a clearly defined procedure in the standard to recognize revenue from the contracts with customers.

It is typical for developers and construction companies to draw up long-term contracts, and the biggest problem in this case is how to resolve the issues of revenue recognition: during the entire construction period (at the end of the reporting period), or at a certain point after construction is completed (upon completion of construction and

commissioning). These issues are within the competence of an economic entity and are reflected in the accounting policy of an organization.

IFRS 15 is not intended solely for construction contracts, but is quite applicable for determining revenue from continuing contracts. Thus, in the paragraph 41 of IFRS 15, the appropriate methods for assessing the degree of fulfillment include output methods and resource methods. And the par. B14 - B19 provide guidance on the use of output methods and resource methods to assess the extent to which an entity has met a performance obligation. In the case of construction contract performance, organizations can use the resource method to assess the degree of completion.

IFRS 15 has a five-step revenue recognition model:

- Identification of the contract with the buyer;
- Determination of obligations under the contract;
- Determination of the transaction price;
- Allocation of the transaction price to the obligations under the contract;
- Recognition of revenue at the time the company fulfills (or during fulfillment) its obligations under the contract (Alotibi, 2018).

Figure 1 schematically shows the revenue recognition algorithm in the construction industry.

Let's consider the mechanism of revenue recognition in construction companies. For example, the construction company XXX signs a contract for the construction of a building and installation of water heating equipment in March 20x1. The contract value is 10 million of CU. The total estimated costs are 8 million of CU. (5 million of CU for the purchase of equipment and 3 million of CU for labor, material and other costs).

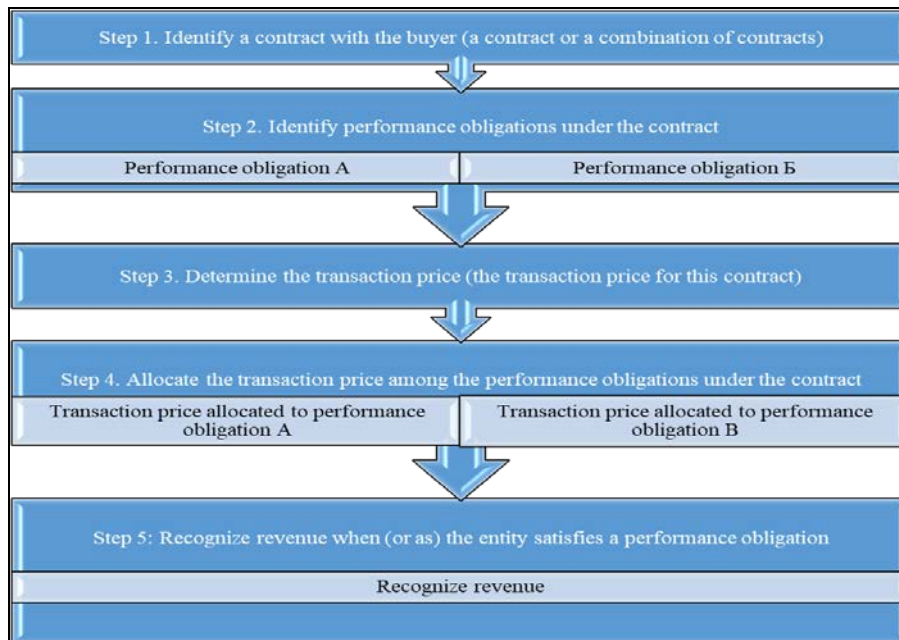


Figure 1: Algorithm for revenue recognition in accordance with IFRS 15 "Revenue from the contracts with customers"

As of 31.12.202x1, the company XXX has handed over the water heating equipment, but its installation has not been completed yet. The client got control of the equipment. Other expenses incurred on 31.12.20x1 amounted to 1 million of CU. In November 20x1, the customer made the first contract payment of 7 million CU.

First, you need to identify the contract with the buyer. According to IFRS 15, revenue is income arising from the ordinary activities of an entity.

Income represents increases in economic benefits during the reporting period in the form of receipts or improvements in asset quality or decreases in liabilities that result in equity increase which is not attributable to contributions by equity participants.

IFRS 15 led to significant changes in the revenue and profit recognition model, and to increased complexity in the accounting process of construction companies. Regular construction contracts contain several performance obligations that are fulfilled at different times.

This requires accountants to assess whether goods or services are recognized at a point in time or over a period, whether goods or services are distinct or must be combined with other goods or services when revenue is recognized, and whether discounting is required to account for the time value of money in long-term contracts.

During the first step, based on the conditions of the example, we can conclude that we are dealing with a contractual agreement between the company XXX and the buyer.

The second step is to identify the performance obligation. The contract includes a promise to transfer goods or services to the buyer. In this case, construction companies must identify each promise in the contract with the customer. The promise is treated as a performance obligation. However, promises are considered distinct if the following criteria are met: the customer can benefit from the service. An entity promise to transfer a construction service to a customer can be separately identified from other contractual promises.

Based on the conditions of the example, the installation of water heating equipment is one general obligation.

During the third step it is necessary to determine the transaction price. The transaction price is the amount of the contractual consideration that the company expects to receive for the provided goods or services. It can consist of a fixed amount or a variable portion of the remuneration. Based on the terms of the example, the contract price makes 10 million CU.

During the fourth step, the transaction price is allocated to individual performance obligations. If a company has two or more obligations in a contract, then it is necessary to allocate the transaction price to them based on their relative selling prices.

Based on the conditions of the example, the entire transaction price is allocated to one liability of the company XXX.

During the fifth step, revenue is recognized when obligations are fulfilled or in the process of their fulfillment. Revenue is recognized when the customer obtains control of the asset. In the case of multiple contracts, as the part of the construction services provided has been transferred, that is, the company has fulfilled each distinct contractual obligation.

According to the paragraph 9 of IFRS 15, it is necessary to analyze how the transfer of control over the asset occurs from the seller to the buyer: at a certain point in time (after completion of work) or over time (as the asset is created or services are provided) (Alotibi, 2018).

IFRS 15 defines control as the ability to:

- a) determine how the asset is used;

- b) receive virtually all of the remaining benefits from the asset, as well as discourage others from doing the same.

IFRS 15 defines the criteria by which one can state that a transfer of control occurs over time. Any contract should be assessed for the presence or absence of these criteria.

Based on the conditions of the example, XXX uses the input method based on the ratio of costs incurred currently to total expected costs. It should be borne in mind that there may not be a direct link between the costs incurred currently and the transfer of service control to the client.

In our example, the company XXX believes that the cost of purchasing water heating equipment constitutes a significant part of the total contract costs and it would be inappropriate to include these costs in the assessment of the part of the work performed, since this overestimates the estimate.

The reason is that the equipment is purchased from third parties and their transfer is not directly related to the construction work performed by XXX under the contract.

Therefore, the assessment of the completed part of the work is carried out without the purchase cost of water heating equipment. Based on the conditions of the example, we will calculate the coefficient and evaluate the completed part of the work:

- general expenses, excluding the purchase of equipment: 3 million of CU;
- total currently incurred costs, excluding equipment: 1 million of CU;
- the ratio of work performed is 1 million/3 million = 33.3%;
- total contract revenue excluding equipment: CU 5 million (CU 10 million - CU 5 million);
- revenue as OF 31.12.20x1, excluding equipment: CU 5 million \* 33.3% = CU 1.67 million

Thus, we see that for the recognition of revenue in accounting for ongoing construction contracts, it is possible to use the procedure disclosed in IFRS 15 after fixing it in the accounting policy.

A different situation arises when determining revenue for tax purposes. When using the considered option of income recognition in accounting, income and expenses in



accounting will be recognized later than in tax accounting.

Since in tax accounting revenue should be allocated between tax periods, and it will be recognized only upon completion of work in accounting, temporary differences inevitably arise and, accordingly, deferred tax liabilities and assets. The differences will be deductible for income and taxable for expenses. The presence of temporary differences will significantly complicate accounting.

If a decision is made to reflect the proceeds as soon as they are ready, then this should be fixed in the accounting policy (the clause 17 of PBU 9/99) (Alotibi, 2018). Revenue from contracts, the duration of which is more than one reporting year or the start and end dates of which fall on different reporting years, are recognized in accounting and reflected in the statement of financial results either via “as ready” method or based on the amount of expenses incurred, considered possible for compensation (the clauses 1, 2, 17, 23 of PBU 2/2008) (Alotibi, 2018). At the same time, if the stages of work are highlighted in the contract, the revenue in accounting under such a contract is recognized as of the reporting date both for completed and unfinished and not accepted by the customer.

But, in the absence of acceptance of completed work, service stages, the recognition of virtual income in tax accounting at the end of the year without reflecting revenue in accounting will entail the need to use the Accounting Regulation “Accounting for corporate income tax calculations” of PBU 18/02 (Alotibi, 2018).

The procedure for the contract price distribution between the reporting (tax) periods is determined by the accounting policy of the organization.

In the presence of production facilities, if the terms of the concluded contracts do not provide for the phased delivery of works (services), the income from the sale of these works (services) should be distributed by the taxpayer independently for reporting (tax) periods in accordance with the principle of expenses development for the specified works (services).

If the terms of the concluded agreement do not provide for the phased delivery of work, the income from their implementation is distributed by the taxpayer independently, taking into account the principle of uniformity of income recognition based on accounting data. At the same time, the principles and methods according to which the income from sales is distributed must be approved in the accounting policy for the purposes of taxation of profits (the Article 316 of the RF Tax Code) ( Terentyeva et al., 2018; Terentyeva et al., 2019;

Vasilenko & Titova, 2019).

The calculation of the notional income tax on profit is recorded in an accounting statement or other tax register developed by a construction company.

At the same time, incomes can be distributed by reporting periods in one of two ways prescribed by the accounting policy of a construction organization: evenly between the reporting periods during which works (services) are performed, or in proportion to the share of expenses during the reporting period.

#### 4. CONCLUSION

Despite the complexity of Russian and international standards, they allow construction companies to single out the significant revenue streams and the types of contracts that will create the main cash flow of a construction company. This interpretation will allow the management of an economic entity to choose those transactions for which it is most beneficial in terms of the amount of proceeds and the contract term ratio.

Thanks to the control system contained in IFRS 15, construction companies will gradually improve their revenue recognition accounting system and eliminate the customer risks associated with contracts.

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