PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS (Q&As)

Q&A No. 2020-02

Conclusion on PIC QA 2018-12E: On certain materials delivered on site but not yet installed

Issue
How should the uninstalled materials be considered in measuring the progress of the performance obligation?

Background
The real estate contract to sell qualify for percentage of completion for its revenue recognition. In order to fulfill its obligation, real estate developers enter into supply contracts with suppliers for the provision and installation of materials as follows:

1. **Customized materials.** These are materials specific to the design, measurements and structure of the projects. The terms of the contract include, but are not limited to the following:

   a) To supply materials that are manufactured and assembled at supplier's site as these require use of precision equipment and machinery for customization. Examples are (a) architectural materials (kitchen cabinets, doors and windows), (b) electrical components (panelboards, bus duct), (c) plumbing/sanitary; and (d) conveying equipment; among others.

   b) Materials are assembled and retained in supplier's site until completed and will be installed based on agreed schedule as these are impractical to store in project site to avoid damages. The installation instructions are also agreed between the real estate developer and the supplier.

   c) The customized materials cannot be used for any other projects aside from the project to which it was measured and fitted to be installed.

   Cancellation of orders are not allowed. In the event that the real estate developer fails to pay for the balance of the customized materials, the supplier forfeits any previous payments the developer has made and supplier is entitled to repossess the merchandise. The supplier forfeits the developer's down payment for cancellation of order for reasons other than guaranteed circumstances.

2. **Materials that are not customized.** These are materials that are not customized but are already delivered on site but not yet installed or used in construction. Examples are gravel, sand, hollow blocks, steel and elevators.

Conclusion and Discussion

The PIC has concluded that in recognizing revenue using a cost-based input method, customized materials are to be included in the measurement of the progress of work while materials that are not customized should be excluded.

Paragraph 39 of PFRS 15 requires that for each performance obligation satisfied over time, an entity shall recognize revenue by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (i.e. the satisfaction of an entity's performance obligation).

As indicated in paragraph B18 of PFRS 15, under the input method, revenue is recognized on the basis of the entity's effort or inputs to the satisfaction of a performance obligation.

In the case of the customized materials, the real estate developer is not just providing a simple procurement service to the customer as it is significantly involved in the design and details of the manufacture of the materials. The customization and manufacture of the materials, which is done at the supplier site, is the more significant portion of the work compared to the installation portion at the project site. Moreover, the customized materials have no alternative use to the real estate developer as these cannot be used in any other project. As such, the costs incurred on the customized materials, even if still uninstalled, are to be included in the measurement of progress to properly capture the efforts expended by the real estate developer in completing its performance obligation.

The Company should maintain adequate records and adopt robust systems and processes that will help ensure proper monitoring of the progress of work and related costs incurred on customized materials that are manufactured or assembled at suppliers' sites.

In the case of uninstalled materials that are not customized., since the real estate developer is not involved in their design and manufacture, revenue should only be recognized upon installation or use in construction. Revenue cannot be recognized even up to the extent of cost because all criteria under paragraph B19(b)(ii) are not met.

Effective date

The effective date of the consensus in this Q&A follow that of PIC QA 2018-12, upon approval by the FRSC.

Date approved by PIC: <u>October 29, 2020</u>

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Date approved by FRSC: **November 6, 2020**

References:

PFRS 15.39 For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognize revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (i.e. the satisfaction of an entity's performance obligation).

PFRS 15.B18 Input methods recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

PFRS 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. [Refer: Basis for Conclusions paragraph BC176] 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 recognize 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, labor or other resources that were incurred to satisfy the performance obligation). **[Refer: Basis for Conclusions paragraphs BC177 and BC178]**

(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 recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize 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; **[Refer: Basis for Conclusions paragraphs BC170–BC175]**

(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).