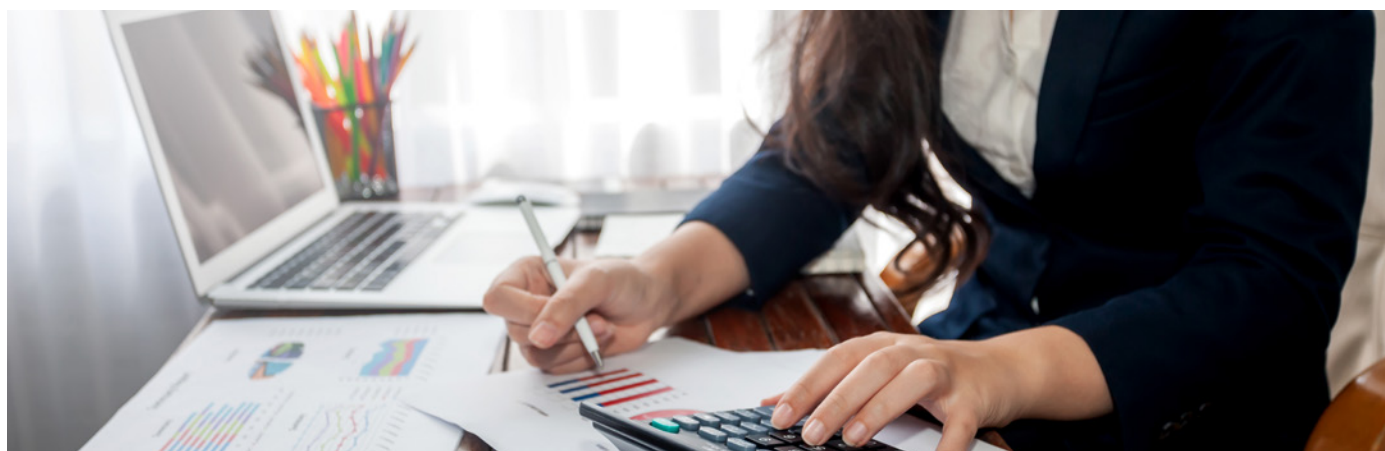


ADVISOR ALERT

ASPE and ASNPO: How changes to Section 3400 Revenue could affect your financial statements

Last updated May 2023



PART 3

Applying the percentage of completion model

Introduction

Financial statement preparers that apply Accounting Standards for Private Enterprises (ASPE) or Accounting Standards for Not-for-Profit Organizations (ASNPO) will want to review their revenue recognition accounting policies to consider additional guidance. For many entities, accounting for revenue can be complex as every revenue stream, sales contract, and transaction can be unique. This additional guidance, now included in Section 3400 Revenue (in Part II of the CPA Canada Handbook – Accounting), eliminates room for interpretation in many areas; however, professional judgment will still be required.

In Part 3 of this three-part series, we provide further guidance on applying the percentage of completion model. At a high level, we'll discuss what an entity should consider in each step of the process when applying this method. The other publications in this series address the following topics:

PART 1

Five-step revenue recognition assessment model

PART 2

Determining the appropriate manner and timing of revenue recognition

In this series, we explain some of the additional guidance included in Section 3400 and provide practical insights to help financial statement preparers and users evaluate the impact of these changes on an entity's financial statements.

Practitioners are encouraged to read this series of publications in order and alongside Section 3400 to fully understand the requirements, as accounting for revenue contains many nuances. As entities prepare their financial statements under amended Section 3400, it's important to also take note of CPA Canada's publication, "[ASPE briefing: Additional guidance added to Section 3400 Revenue](#)", which provides:

- detailed guidance on each of the areas of revenue recognition impacted by the amendments;
- application guidance for not-for-profit organizations;
- additional resources; and
- comprehensive illustrative examples

For further background on the Accounting Standards Board's 2019 amendments to Section 3400, see [Advisor Alert: How Section 3400 Revenue amendments could impact your enterprise's financial statements](#).

The percentage of completion model

When an arrangement (or unit of account within the arrangement) represents the provision of services or a long-term contract, an entity must recognize revenue using either the percentage of completion method or the completed contract method (see Part 2 for details on determining whether an arrangement is a provision of service or a long-term contract).

An entity must recognize revenue using the percentage of completion method if the service or long-term contract does not meet the criteria of the completed contract method. Specifically, the completed contract method can **only** be applied when:

- the service or long-term contract consists of the execution of a single act; or
- the extent of progress towards completion cannot be reasonably estimated.

We've developed a four-step process to guide practitioners through applying the percentage of completion method appropriately and in accordance with ASPE, as follows:

| | | | |
|---|--|---|---|
| A | Determine the appropriate basis to measure progress (e.g., costs incurred, units produced, number of acts) | C | Calculate the percentage of completion |
| B | Determine total contract revenue and total estimated contract costs | D | Calculate the revenue and cost of sales to recognize in income for the reporting period |

STEP 1

Determine the appropriate basis to measure progress

(e.g., costs incurred, units produced, number of acts)

- Perform this step only once at the beginning of the project
- Select a basis of measurement that:
 - relates as directly as possible to the activities that are critical to the completion of the service or long-term contract
 - can be tracked with a reasonable amount of precision; and
 - the entity can estimate throughout the entire project
- The two methods that an entity can use to measure the percentage of completion are the input method and the output method. Once the method is selected, use it to identify an appropriate basis of measurement

| Input method | Output method |
|---|---|
| Measures progress towards completion in terms of efforts devoted to the contract | Measures progress towards completion in terms of results achieved |
| Generally, most appropriate when there is a relationship between a unit of input and the amount of productivity and/or profits are earned in all (or most) phases of operations | May be appropriate when separate units of output are produced or progress can be measured based on units of work completed |
| Some examples of input measures: <ul style="list-style-type: none"> • Total costs • Labour hours • Machine hours | Some examples of output measures: <ul style="list-style-type: none"> • Units produced or completed • Units delivered • Contract milestones |

- Amounts billed is **NOT** an appropriate basis of measurement

★ **In rare circumstances, revenue can be recognized on a straight-line basis (i.e., the basis of measurement is time incurred). Revenue can be recognized on a straight-line basis only when:**

1. performance on the service or long-term contract involves an indeterminate number of acts over a specific period of time; and
2. there is no evidence to suggest that another basis of measurement would be more appropriate in reflecting how the work is performed

(Paragraphs 3400.A27-.A32)

STEP B

Determine total contract revenue and total estimated contract costs

- Perform at each reporting period end and update for any contract revisions, modifications, or revised estimates
- **Total contract revenue** is the total amount that will be earned from the service or long-term contract (or the amount allocated to the unit of account to which the service or long-term contract belongs if it is part of a multiple element arrangement)
- **Total estimated contract costs** include costs that:
 - Relate directly to the contract (e.g., labour, materials);
 - Are attributable to contract activity in general and can be allocated to the contract (e.g., insurance, overhead)
 - Are specifically chargeable to the customer under the terms of the contract (e.g., general administration costs); and
 - Are incurred in pursuit of securing a contract (e.g. sales commission for securing the contract) as long as:
 - the costs are separately identifiable;
 - the costs are reliably measurable; and
 - it is probable that the contract will be obtained
- Costs that should not be included in the total estimated contract costs include general selling costs, amortization of idle plant and equipment, general administration costs and research and development costs that are not specified in the contract for reimbursement
- Any cost that is not considered part of total estimated contract costs is expensed as incurred

[Paragraphs 3400.A27-.A32]

STEP C

Calculate the percentage of completion

- Perform at each reporting period end
- Regardless of the basis of measurement selected, use the following formula to calculate the percentage of completion (POC):

The diagram shows the formula for POC. On the left, 'POC' is written in large white letters on a teal background. To its right is a white circle containing an equals sign. A horizontal line extends from the right side of the equals sign circle to the right, separating the numerator from the denominator. The numerator is 'The total of the basis of measurement selected in Step A accomplished to date'. The denominator is 'Total amount of the selected basis of measurement needed to complete the contract'.

$$\text{POC} = \frac{\text{The total of the basis of measurement selected in Step A accomplished to date}}{\text{Total amount of the selected basis of measurement needed to complete the contract}}$$

- When **total costs** are used as the basis of measurement, the numerator in the calculation represents costs incurred that reflect work performed to date
- **Judgment is often required to determine when costs should be included in the measure of total costs**
For example, the cost of components/materials may be excluded from the measure of total costs until they are installed in order to avoid a material overstatement of the degree of completion

[Paragraphs 3400.A20-.A22]

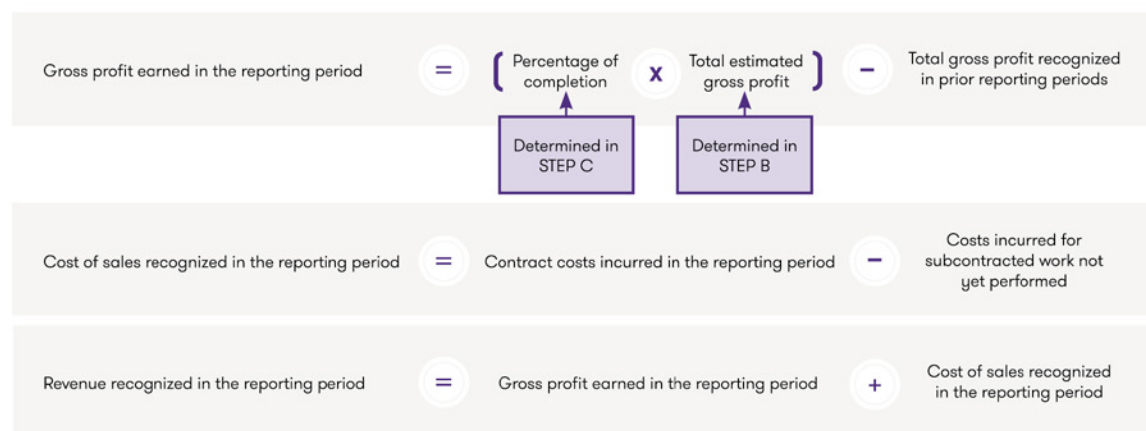
Calculate the revenue and cost of sales to recognize in income for the reporting period

- Perform at each reporting period end
- Section 3400 outlines two possible approaches for calculating the revenue, cost of sales and gross profit to recognize in the reporting period. An entity must apply the selected approach consistently to all contracts accounted for using the percentage of completion method

Alternative A



Alternative B



In addition to recognizing the impact of a contract on the income statement, an entity may also need to recognize impacts on the balance sheet

1. Amounts billed vs. revenue recognized
 - When, at the reporting date, total amounts billed exceed total revenue recognized, recognize a liability on the balance sheet (e.g., deferred revenue)
 - When, at the reporting date, total amounts billed is less than total revenue recognized, recognize an asset on the balance sheet (e.g., estimated earnings in excess of billings)
2. Contract costs incurred vs. cost of sales recognized
 - When, at the reporting date, total contract costs incurred exceed total cost of sales recognized, recognize work-in-progress inventory on the balance sheet
 - When, at the reporting date, total contract costs incurred is less than total cost of sales recognized, recognize a liability on the balance sheet (Note: this situation is rare)

(Paragraphs 3400.A24-.A25)

Account for any contract modifications, revised estimates, and contract losses

Be on the lookout for any of these considerations while working through steps B, C and D

- Contract modifications are documented changes to a contract that impact the total amount of revenue and/or the total estimated contract costs of that contract
- Revised estimates occur anytime an entity determines that one or more of its original estimates needs to be updated as a result of new information or developments (i.e., changes in the market price of goods and/or labour, changes in work effort, or as work progresses on a project and experience is gained)
- A contract loss occurs when the total estimated contract costs for a service or long-term contract are expected to exceed total contract revenue
 - Contracts must be assessed for losses on an individual contract basis rather than on a cumulative basis
 - The entire amount of the expected loss is immediately recognized into income as soon as it becomes probable, regardless of whether management believes that the contract will become profitable in a future period
- Contract modifications, revised estimates and contract losses are recognized in net income on a **prospective** basis in accordance with Section 1506 *Accounting changes*



If a contract modification, revised estimate, or contract loss should have been identified in a prior reporting period, this represents an accounting error and must be recognized **retrospectively** in accordance with Section 1506 *Accounting Changes*

(Paragraphs 3400.A26, .A33-.A34)

Additionally, refer to Grant Thornton's other publications on revenue recognition:

PART 1

Five-step revenue recognition assessment model

PART 2

Determining the appropriate manner and timing of revenue recognition

We can help.

If you have any questions about the amendments or applying the five-step revenue recognition assessment model, reach out to your Grant Thornton advisor today.



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