A CONSTRUCTION COMPANY'S GUIDE TO THE NEW REVENUE RECOGNITION STANDARD

MARCUM
ACCOUNTANTS ▲ ADVISORS

The Financial Accounting Standards Board (FASB) released a number of New Guidance in 2014 for companies that file their financials in accordance with the Generally Accepted Accounting Principles (GAAP) in the United States of America. These changes are largely connected with the goal of merging GAAP standards with the International Accounting Standards Board's (IASB) International Financial Reporting Standards (IFRS). Among these changes was ASU 2014-09, Revenue from Contracts with Customers ("ASC 606" or "the New Guidance") which will have a notable impact on businesses in the construction industry as it is designed to have all entities recognize revenue using a common conceptual framework versus the current method of recognizing revenue based on methodologies that differ from industry to industry.

To address the complexity of changes to revenue recognition, Marcum LLP formed an internal task force to address implementation issues of ASC 606 for contractors. This group will provide guidance on how the new standard affects our clients and how it is implemented for various industries with Robert Mercado representing the Marcum Construction Group.

The new standard applies to all contracts with customers, which are defined as parties that have contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration (think payment). This definition includes sales of fixed assets and intangible assets.

The New Guidance does not apply to lease and insurance contracts, financial instruments, guarantees, and certain nonmonetary exchanges.

It is common to have many questions about how the New Guidance applies to your contracts. And it is difficult to quickly answer all of your questions – since the New Guidance is principles based and requires the application of all five steps to make a final determination on how revenue is recognized. One common question is whether the New Guidance continues to allow the percentage of completion accounting methodology that is commonly used by construction companies for long term contracts. You will be happy to hear that the New Guidance does allow this type of approach. However, it has a new name, it is now called a contract with multiple performance obligations that are not distinct where control transfers over time (for simplicity, we will refer to a contract that meets this criteria throughout this article as a Long Term Contract (LTC) where Control Transfers Over Time). Further, there are some significant changes to how the methodology is applied which we will explain throughout this article.

Effective Dates

	Private Companies	Public Companies
Effective for Reporting Periods	Beginning after December 15, 2018 (calendar year 2019)	Beginning after December 15, 2017
Early Adoption	Early adoption allowed for reporting periods beginning after December 15, 2017	Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

Two Options for Adoption of the New Guidance

Full Retrospective Method (Cumulative Effect Adjustment to Retained Earnings in the Earliest Period Presented)	Simplified Approach (Modified Retrospective Application with a Cumulative Effect Adjustment to Retained Earnings in the Year of Adoption)
Company restates all periods presented as if they had been accounted for under ASC Topic 606 originally; comparative periods would be restated.	Company applies the New Guidance to contracts that are ongoing as of the effective date and new contracts going forward. The cumulative adjustment to the opening balance sheet is reflected in retained earnings; disclosures in the financial statements must explain differences in each financial statement line item between ASC 606 and the method used prior to adoption. Comparative periods do not require restatement.

WHICH APPROACH IS RIGHT FOR YOUR BUSINESS?

Construction companies should decide which option is a better fit for their businesses after a careful review of their contracts. Should there not be any substantial changes in revenue recognition for a given business, that organization is able to implement either of these methodologies. Meanwhile, the simplified approach is recommended for those businesses that realistically forecast many changes in revenue recognition. Many large companies will likely utilize the full retrospective method that will require entities to restate comparative prior periods presented in current financial statements. Meanwhile, privately held construction entities may opt for the modified retrospective method instead and disclose the difference between prior period (old method) and current period (New Guidance).

FASB'S AND IASB'S FIVE-STEP PROCESS

The New Guidance intends for companies to recognize revenue in an amount that depicts "the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

FASB and IASB outline a five-step process to apply this principle.

1 Identify the contracts with a customer.

2 Identify the performance obligations in the contract.

3 Determine the transaction price.

4 Allocate the transaction price to the performance obligations in the contract.

5 Recognize revenue when/as reporting organization satisfies a performance obligation.

1. IDENTIFY THE CONTRACTS WITH A CUSTOMER.

A contract exists when there is an agreement between two or more parties with enforceable rights and obligations.

A contract exists if:

- The contract has commercial substance.
- The contract has been approved by all parties involved and all parties have made commitments to meet the terms outlined.
- The contract has enforceable rights regarding goods or services to be delivered.
- Identifiable payment terms exist.
- The party providing goods or services is likely to collect what is expected in exchange for goods or services rendered.

Entering into a written contract with a customer is likely to meet these criteria for a construction company.

These criteria may also be met with an oral agreement.

2. IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT.

Under the new standard, businesses must determine the performance obligations associated with each contract. To accomplish this, businesses need to decide if goods or services are distinct, which means that the customer can benefit from said good or service on its own (i.e. not interdependent on other goods or services, meaningfully changes other goods and services in a contract, or is integrated into another service).

An entity must treat each distinct performance obligation within a contract separately, allowing revenue recognition when that obligation is delivered. However, many contracts in the construction industry include multiple performance obligations that are not distinct and must be bundled together to determine the appropriate pattern of revenue recognition.

Performance Obligation
Defined by Topic 606 as a promise (explicit or implicit) to transfer a distinct good or service (or a bundle of distinct goods and services).

Warranties

Future warranty costs need to be considered in all contracts, including a LTC Where Control Transfers over Time. Cases might exist where significant warranties would be considered separate performance obligations.

Assurance Type	Service Type
Provide assurance to the customer that the product or service will comply with the agreed-upon specifications	Provide service in addition to providing assurance related to the product complying with the agreed-upon specifications
▪ Considered part of the required product the entity is delivering ▪ Not considered a separate performance obligation ▪ In a LTC Where Control Transfers over Time, the cost to deliver the warranty must be included as part of the total costs of the contract.	▪ Promises to provide the service to the customer in addition to the product that has the functionality described in the contract ▪ Considered a separate performance obligation ▪ Allocate a portion of the transaction price to that performance obligation
If an entity provides both an assurance type and service type warranty in a contract, the entity must allocate part of the transaction price to the service type warranty. If the entity is unable to determine the transaction price for just the service type warranty the entity must allocate part of the transaction price to a separate performance obligation that includes both the assurance type and service type warranties.	

3. DETERMINE THE TRANSACTION PRICE.

The amount a business expects to receive in exchange for meeting the performance obligation(s) outlined in the contract is the transaction price and includes the effects of the following:

- Variable consideration
- Consideration payable to a customer
- Noncash consideration
- Significant financing components

Transaction Price
Defined by Topic 606 as the amount of consideration to which an entity expects to be entitled in exchange for the transferring promised goods or services to a customer.

Change Orders

With change orders common in construction, businesses in the industry should appreciate that these changes as well as unplanned claims and incentives must also be considered. How change orders are accounted for depends on whether they are distinct from the original contract.

	Pricing	Scope	Result
Distinct Change Orders	Stand-alone pricing	Separate from the performance obligations outlined in the original contract	New contract
Vs.			
Continuation Change Orders	Add-on pricing	Interdependent with the work promised in original contract	Cumulative obligation

This marks a change from the current GAAP standards which dictate that change orders are usually added to the overall contract value with any additional estimated costs to complete the project, and gross profit is based on the updated percentage of completion.

Accounting for Variable Consideration with Probabilities

Variable consideration can be items such as awards and incentives for completing a contract ahead of schedule or under budget. The concept of variable consideration marks an important change from the current guidance. Variable consideration requires management to estimate pricing if a formal change order has not been finalized. The New Guidance requires management to utilize probabilities related to change orders to determine whether and how much of the change order should be added to the contract. This might allow companies to recognize claims revenue and unapproved change orders that would have been historically unallowable.

Variable consideration is accounted for using either the expected value approach or the most likely amount approach, depending on which is the optimal predictor of the amount to be received. When calculating variable consideration, the business should use all available information (e.g. business and customer history and current as well as forecasted information).

The New Guidance emphasizes that the amounts are only included in the contract price if it is probable that there will not be a significant reversal in the amount of cumulative revenue recognized. This new approach requires careful documentation and support to create an audit trail for the decision-making process. During the contract term, any significant modifications in expected revenue from the transaction would be accounted for in the current reporting period by updating the contract value based on the significant modifications.

The New Guidance allows the entity to recognize revenue and profit on a claim only if it is probable that a significant reversal of the revenue recognized will not happen in the future. When assessing this probability, it is important to understand factors that could impact a revenue reversal include, but are not limited to, any of the following:

- The amount of consideration is highly susceptible to factors outside the entity's influence (i.e., volatility in a market, the judgment or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service).
- Resolution to the uncertainty about the consideration amount not expected to occur for a long period of time.
- The entity's experience (or other evidence) with similar types of contracts is limited or has limited predictive value.
- The entity often offer a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a broad range of possible consideration amounts.

Noncash consideration

Noncash consideration is goods or services provided by a customer to an entity. It must be determined whether an entity takes possession of a good or service (asset) prior to delivering the asset to a customer. The New Guidance is consistent with the current guidance related to construction managers not at risk. The construction manager not at risk is only permitted to recognize revenue to the extent of the fee for the specific contract.

4. ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT.

When the business determines a contract has more than one performance obligation, the transaction price is allocated to each performance obligation based on an estimate of stand-alone selling prices. Once the transaction price has been determined for each performance obligation the transaction price is only adjusted for modifications and variable considerations. The company is not permitted to reallocate the transaction price in future periods.

5. RECOGNIZE REVENUE WHEN/AS THE REPORTING ORGANIZATION SATISFIES A PERFORMANCE OBLIGATION.

With the New Guidance, revenue is recognized once performance obligations are met. This occurs when control of the good or service transfers to the customer; this transfer can take place at single point in time or over a period of time.

In the construction industry, control is often transferred over time, which is defined as meeting one of the following three criteria:

- A customer receiving and consuming benefits of the performance as it is performed.
- A contractor's performance creating or enhancing a customer-controlled asset.
- An asset with an alternative use to the contractor not being created, but the contractor having the right to payment for performance completed to-date.

The New Guidance offers two methodologies for measuring progress towards completion: the input method and output method.

Output Method

- Surveys of performance completed to date
- Appraisals of results achieved
- Milestones reached
- Units produced or units delivered

Input Method

- Resources consumed
- Labor hours expended
- Costs incurred
- Time lapsed
- Machine hours

Contract provisions should be assessed to determine how which method for recognizing revenue more faithfully depicts the entity's progress towards completion of its performance obligation. Further, an entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances.

Significant Inefficiencies in Performance

If an entity incurs significant inefficiencies in performance on a contract, these costs must be removed from the contract and expensed as incurred. Under the New Guidance, these costs would not be included in the estimated cost of the project and cost incurred to date thereby affecting the current year financial statements.

Uninstalled Materials

Goods purchased for a project but not yet installed or used on the project are called uninstalled materials. At times, construction entities may hold substantial quantities of materials that have not been installed or used in a specific contract and therefore control has not been transferred to the customer. The New Guidance states that costs related to these materials cannot be included in a contract where control transfers over time (and therefore, revenue may not be recognized related to these materials). This is because these costs do not represent progress towards completion of the contract until they have been installed or used in the specific contract. Until these materials are installed/used in a specific contract, they must be accounted for as inventory assets on the balance sheet.

Costs Incurred that are not Indicative of Performance

The New Guidance explains that an entity should exclude from an input method the effects of any input that does not depict the entity's performance in transferring control of those goods or services to a customer. The New Guidance also states that when a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation, 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. In this situation, if all of the following are met, the entity should only recognize revenue to the extent of the cost incurred on the non-proportionate costs items incurred:

- The good is not distinct.
- The customer is expected to obtain control of the good significantly before receiving services related to the good.

- The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
- 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).

Additionally, when the materials, originally accounted for as uninstalled materials but revenue was recognized equally to the cost of those materials, are now installed, the entity would be required to determine the most appropriate accounting treatment for those materials. What this is saying is, once the materials are installed on the project the entity would need to determine if the materials should be included in the calculation of the percentage of completion using the cost-to-cost method or would the materials incorrectly depict the percent complete on the project compared to the actual production of the entity on the project. The entity would be required to determine if those materials should be included in the calculation of percent complete at any point, if ever, on the project or utilize other methods to determine the actual percent complete based on the performance of the entity. Based on this, the materials may be accounted for as a separate subset of the project with revenue equaling cost through the completion of the project while the main contract would recognize the gross profit based on the percent complete excluding the cost of the materials in the separate subset. If the entity believes that the recognition of the materials on the project relate to the actual performance of the entity's percent complete, the entity would need to do a cumulative catch up adjustment for the gross profit on the project in the period in which the materials are included in the cost-to-cost calculation.

Contract Asset or Liability

The New Guidance requires recognition of a contract asset if the contractor provides the goods or services to a customer before the contractor is paid for it. Conversely, a contract liability is to be recognized if a customer pays before the contractor delivers goods or services to a customer.

Retainage

Under the current standards, retainage is considered a contract receivable as the project progresses. The New Guidance requires retainage to be included in contract assets and liabilities until all of the performance requirements are completed by the entity. Once retainage conditional based only on the passage of time, retainage will be reclassified to a receivable or payable from contract asset or liability.

Loss Contracts

The New Guidance is consistent with the current guidance; the entity is required to record the loss in its entirety once it is determined a loss will be incurred on the contract. If a contract is reported as multiple performance obligations and one of those performance obligations will result in a loss for that performance obligation but not for the entire contract, the entity may elect to accrue the loss on the specific performance obligation but is not required to.

Capitalizing Contract Costs – Cost Incurred that does not transfer value

An entity cannot recognize revenue related to costs that has no value for the customer. These costs include bond cost, mobilization and contract start-up administrative costs, to name a few. For example, moving equipment to a site does not provide value to the customer, therefore, the site contractor would not be able to recognize revenue associated with those costs. Instead those mobilization costs would be amortized over the life of the contract.

DISCLOSURE REQUIREMENTS

The new standard continues the FASB's recent trend of providing private companies with reduced disclosure requirements compared to public companies. Some new disclosure requirements for private companies include:

- Transition method of adoption (full or modified retrospective method)
- Information that enables financial statement users to understand four aspects of revenue and cash flows from customer contracts: nature, amount, timing and uncertainty
  - Revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts
  - Disaggregation of revenue – Type, location, etc.
- Contract Balances:
  - Contract assets and contract liabilities (including changes in those balances)
  - The amount of revenue recognized in the current period that was previously recognized as a contract liability
  - The amount of revenue recognized in the current period that is related to performance obligations satisfied in the prior periods
- Performance Obligations
  - Types of goods or services
  - Significant payment terms
  - Typical timing of satisfying obligations
  - Other provisions
- Quantitative disclosure of the "aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially satisfied)" and when the entity expects to recognize that amount as revenue
- Significant judgments and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations)
- Cost to obtain or fulfill a contract (including account balances and amortization methods)
- Policy decisions (i.e. whether the entity used the practical expedients for significant financing components and contract costs allowed by ASC 606).

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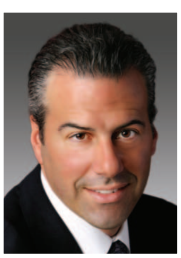
National Construction Industry Services Leaders



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Joseph Natarelli is the national leader of Marcum's Construction Industry Practice and an office managing partner in New Haven. For more than a decade, he has served as a technical reviewer for the AICPA's Audit Risk Alert for Construction Contractors and the AICPA Accounting Guide – Construction Contractors. Joe has also chaired the annual AICPA National Construction Industry Conference.

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