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Key Revenue Recognition Terminology Changes May Impact Contracts & Project Schedules

What do the recent changes to FASB's Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers* (Topic 606) mean for the construction industry? Topic 606, effective for private companies for years beginning after December 15, 2018, supersedes most industry-specific revenue recognition guidance.

In our experience, the vast majority of construction companies have historically recognized revenue using the percentage-of-completion method (PCM or POC) based on the ratio of costs incurred to date compared to total estimated costs expected to be incurred on the project, often referred to as cost-to-cost. While the cost-to-cost method will likely still be used by many contractors to measure their progress toward satisfaction of performance obligations contained with contracts under Topic 606, there are several important steps to revenue recognition that might not always produce the same results as PCM did under legacy GAAP.

Given these changes, there are areas that will require additional resources from companies, including terminology changes of key words that are integral to the revenue recognition process, and how companies modify and update their internal controls and processes in response to Topic 606.

Topic 606 will require greater communication between operations and accounting departments to ensure that revenue is recognized appropriately. Let's look at some of the terminology changes.

Background

Topic 606 prescribes a five-step process for recognizing revenue:

1) Identify the contract with a customer
2) Identify the performance obligation(s) in the contract
3) Determine the transaction price
4) Allocate the transaction price to the performance obligations in the contract
5) Recognize revenue when (or as) the entity satisfies a performance obligation

Let's look at some of the terminology changes within each of these steps and what they mean for the construction industry.

Step One

The first step is fairly straightforward in construction and doesn't include any significant terminology changes. *Contracts* are defined as agreements that create enforceable rights and obligations between two parties, which can also include implied or verbal agreements.

Steps two through five will likely impact construction companies the most. If a company's internal controls around these steps are inadequate, improper recognition of revenue and errors in required disclosures could occur.

Step Two

New Definition: Performance Obligations

Performance obligations are defined as a promise noted in a contract to transfer a good or a service. This is perhaps the most important aspect of revenue recognition for construction companies because performance obligations must be identified not only at the inception of the contract, but also as modifications occur over the life of the contract. When modifications occur, they must be identified, communicated, and reviewed to ensure that they're properly accounted for.

Claims and change orders are typically evaluated by a member of the operations department, often beginning with the project managers. The level of communication between the operations and accounting departments must be sufficient enough to ensure that nothing is missed. It isn't necessarily about doing things differently; it's about communicating more with the back office.

Qualifying Criteria

There are two criteria for a promised good or service to qualify as a performance obligation in a contract. It must represent one of the following:

- A distinct good or service, or
- A series of substantially similar, but distinct, goods or services that have the same pattern of transfer.

Distinct

During the exposure draft of this pronouncement, the construction industry played a key role and was instrumental in getting clarification that a good or service doesn't just have to be distinct on its own or separately usable by the customer, but it also *must be distinct within the context of the contract*.

To that end, to be considered distinct, a good or service must meet both of the following criteria:

- The customer can benefit from the good or service on its own or together with the resources that are readily available to the customer, and
- The promise to transfer the good or service is separately identifiable from other promises in the context of the contract.

Generally, it is the second condition that will require the most attention by construction contractors in determining if a promise is distinct, and Topic 606 provides three factors to help in making this determination of whether two or more promises in a contract are separately identifiable.

Key questions to help assess whether a promise is distinct include:

1) Does the entity provide a significant service of integrating goods or services with other goods or services in the contract into a bundle of goods or services that represent a combined output which the customer has contracted for?

2) Does one or more of the goods or services significantly modify, or is modified by, other goods or services promised in the contract?

3) Are the goods or services highly interdependent or highly interrelated with other goods or services promised in the contract?

Steps Three & Four
New Definition: Transaction Price

Transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods and services in the contract. The transaction price is allocated based on the relative stand-alone selling price (i.e., the price at which an entity would sell a promised good or service to a customer) at the inception of the contract.

It's important to note that the transaction price may be different than what the contract states.

New Definition: Variable Consideration

This is likely one of the biggest changes affecting the construction industry. *Variable consideration* is the part of the contractual consideration related to a contractor's goods or services that is variable in nature.

Variable consideration must be estimated upon entering into the contract and throughout the performance of the contract and is subject to evaluation of the constraint concept (as described later).

Some examples of variable consideration include:

- Performance bonuses and penalties
- Claims, unapproved or unpriced change orders
- Liquidated damages
- Unit pricing
- Back charges
- Refunds, rebates, and discounts

Liquidated Damages

These are treated differently from how many companies historically accounted for them, which was an increase in estimated costs. Under the new standard, liquidated damages are accounted for as a reduction of the transaction price.

Complexity

Because companies must consider separate performance obligations within a contract, the more performance obligations that are contained in a contract, the more complex it may be to allocate the transaction price to each performance obligation.

While many contractors may want to assume most contracts will be treated as if there's only one performance obligation that produces a combined output, it's important to consider and evaluate whether or not the contract has multiple performance obligations since revenue is recognized at the performance obligation level, not the contract level.

In addition, variable consideration further impacts the determination of the transaction price and must be assessed continuously throughout the process of performing under the terms of the contracts and then again allocated to each performance obligation in a contract that contains more than one.

For example, let's say a construction company enters into a contract to construct an office building and a small parking structure near the office building. The office building and parking structure are considered separate structures because they don't connect and aren't integrated in any other way. As a result, they may be considered two distinct performance obligations within one contract.

In this scenario, the customer can benefit from each structure individually and could hypothetically select a different contractor to build each of the structures without significantly affecting the other. The transaction price specified in the single contract would have to be allocated to each performance obligation – the building and the parking structure – using one of the methodologies outlined in Topic 606.

However, if there are factors to support a conclusion that the two structures are not separately identifiable performance obligations – such as the design requires significant integration of the two structures with the associated site preparation work, utilities, roadway design, and construction, and walkways connecting the two – accounting for them as a single performance obligation would be appropriate.

Estimation Methods

A contract may contain different types of variable consideration, which signals that it may be appropriate for an entity to consider if using different estimation methods is appropriate. There are two methods for estimation of variable consideration: expected value and most likely amount.

A company should select the method based on which one better predicts the amount of consideration to which it will be entitled; in some contracts with multiple elements of variable consideration, a company will need to use a different method on the various elements of variable consideration and such method(s) should be consistently applied to each element of variable consideration through the contract term.

The following are definitions and examples of each method.

Expected Value

This is the sum of probability-weighted amounts in a range of possible outcomes. It may be appropriate when there's a large number of possible outcomes and when a company has a large number of contracts with similar characteristics.

Let's use the same example previously described: $10 million fixed-price contract to construct an underground tunnel and a $500,000 performance bonus if it's completed by January 1. Additionally, if the project isn't completed by January 1, then the company estimates $5,000 per day in liquidated damages. Accordingly, in this example there are two elements of variable consideration – the performance bonus and the liquidated damages – that are both tied to the completion date of the project.

In this instance, the company determines three scenarios of when the project could be completed with associated probabilities for each:

- 25% probability by January 15
- 50% probability by January 31
- 25% probability by February 15

Since it is not probable the performance bonus will be achieved it is assigned a value of zero. The impact of liquidated damages on the transaction price can then be calculated as follows using the expected value method:

- $5,000 x 15 days = $75,000 x 25% probability = $18,750
- $5,000 x 31 days = $155,000 x 50% probability = $77,500
- $5,000 x 46 days = $230,000 x 25% probability = $57,500

The total impact of liquidated damages on transaction price is estimated at $153,750. By subtracting this amount from the $10 million contract price, the transaction price would be $9,846,250 based on the probability-weighted scenarios estimated by management.

Most Likely Amount

This is the single most likely amount in the range of possible consideration amounts and best used in situations with binary outcomes.

For example, if there's a $10 million fixed-price contract to construct an underground tunnel and a $500,000 performance bonus if it's completed by January 1, and the company can determine that it's 80% likely to be completed by January 1.

The transaction price would be $10.5 million because it's the contractor's best estimate that the bonus will be earned based on consistently hitting deadlines for performance bonuses on other similar contracts.

The estimated bonus amount needs to be included in the transaction price at the *inception* of the contract and reevaluated throughout the term of the contract.

This is very different from current methods that are often used because contractors typically defer this recognition until very near the achievement of the target date. This is

one of the reasons why the new standard may accelerate revenue recognition.

Constraint

Variable consideration should only be included in the transaction price (and ultimately recognized in revenue) to the extent it's probable that a significant reversal in cumulative revenue recognized won't occur once the uncertainty is resolved. In the new standard, this is referred to as *constraining estimates of variable consideration*. Typically, a 75-80% chance of occurrence is considered probable.

To make this estimation, companies must evaluate all relevant facts and circumstances, including their histories with the specific as well as similar types of customers, projects, and geographic regions to determine the extent that it's probable that a significant reversal of cumulative revenue recognized will or will not occur.

It is also important that consideration be given to whether the variability is based on factors that are not within the company's influence (e.g., weather, risk of obsolescence, approval of customer funding), as well as the period of time until such uncertainty will be resolved. Both the likelihood and magnitude of a potential revenue reversal should be factored into the evaluation.

Effect on Job Schedules

With the new standard, there are many potential impacts on the job schedules, which have no prescribed form in GAAP.

For example:

- The transaction price could be different than the contractually stated amount because of variable consideration, which includes performance bonuses, liquidated damages, claims, and unpriced change orders. This might necessitate adding a column to show both the contractually stated amount as well as the GAAP transaction price estimated by management for those contracts with variable consideration and the transaction price may change over time, even without any change orders.
- Revenue is recognized at the performance obligation level within a contract while the contract asset or liability is measured at the contract level – meaning that a job schedule might need to show detail of a contract at the performance obligation level of detail with totals at the contract level in order to be mathematically transparent.
- The allocation of the transaction price across multiple performance obligations in a contract could change the timing of revenue recognition depending on the construction schedule and underlying gross profit margins associated with the individual performance obligations.

Internal Control Considerations

Companies will need to modify existing (or design and implement new) controls to address the various elements required in accounting for revenue under Topic 606.

This will include maintaining contemporaneous documentation over the contract evaluation, estimation methodology, and assumptions, including those involving the determination of whether a contract exists, if revenue should be recognized over-time or at a point in time, if more than one performance obligation exists within a contract, effect of change orders and whether they are to be accounted for as a modification of the existing contract or an entirely separate contract, estimates of variable consideration as well as the evaluation of the related constraint.

This is important because the assumptions will change as a project progresses toward completion.

In this step, the transaction price, including appropriate variable consideration, specified in the contract would have to be allocated to each performance obligation (e.g., the aforementioned building and parking example) based on relative stand-alone selling prices. There are several approaches available, such as the adjusted market approach or a bottom-up approach by using the expected cost-plus margin. We believe the bottom-up approach will be most used in the construction industry since it is how contractors typically estimate their projects.

As a last resort, a company may need to consider a residual approach when stand-alone selling prices can be determined for some, but not all, performance obligations; however, this approach is highly discouraged.

Step Five

When the promised good or service is transferred to the customer, revenue is recognized. Assets, including goods or services, are considered transferred when the customer obtains control of them.

New Definition: Control

The biggest change here is the concept of control. *Control* of a good or service refers to the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the asset. While services are not generally a recognized asset on a company's balance sheet, for purposes of Topic 606 services are assets that are often simultaneously received and consumed by the customer.

Qualifying Criteria

An asset is transferred and revenue is recognized when the customer obtains control of that asset in one of two ways:

- At a point in time
- Over time

Typically, many contractors satisfy performance obligations over time.

Revenue is recognized over time if:

- The customer simultaneously receives and consumes the benefits as the contractor performs
- The contractor's performance creates or enhances an asset that the customer controls
- The contractor's performance doesn't create an asset with an alternative use to the customer and an enforceable right to payment exists for performance completed to date throughout the contract

The criteria regarding an enforceable right to payment for performance completed to date is an important aspect that is not always as present as some may believe. For example, if payment is contingent upon meeting certain milestones and no right to payment exists prior to such milestones – even though work has been performed, then this criterion would likely not be met. And, if neither of the other two criteria are met, then all revenue would be deferred subject to the guidance for recognizing revenue at a point in time (at the completion of the performance obligation).

Contract Assets & Liabilities

Contract assets and liabilities will continue to be recognized gross on a contract-by-contract basis on a company's balance sheet. Under legacy GAAP, these were often referred to as costs and estimated earnings in excess of billings and billings in excess of costs and estimated earnings.

The terminology used to describe contract assets and liabilities should likely change slightly because it is no longer "costs plus estimated earnings," but actually estimated revenue. Details of contract assets and liabilities will need to be disclosed, and will include such things as uninstalled materials (when such do not require to be accounted for as inventory) and retainage, as the definition of receivables was modified to exclude any amounts that are contingent upon something other than the passage of time.

Considerations

Construction companies should be keenly focused on new disclosure requirements and internal controls. Accounting software will likely not be able to handle all of the new requirements, so ensuring accurate communication between estimating and accounting departments combined with clear and complete documentation of evaluations and conclusions can help fill the gaps.

Consequences

Waiting to implement necessary changes can have consequences if your company is audited and found to have not sufficiently considered the new standard. Most contractors have some kind of bank debt or bonding, and compliance with GAAP is required to secure this funding. Additionally, some state licensing agencies require GAAP financial statements from contractors as part of their licensing process.

Timeline

This standard is in effect for calendar year-end private companies in 2019. Waiting to make the changes needed to comply with Topic 606 will likely impact the quality of reporting and could create additional work when assessing how this standard impacts your contracts, which may cause significant delays in your ability to prepare your financial statements in accordance with GAAP.

While many companies are electing to adopt this change using the modified retrospective method, even this results in the need to disclose the effect of the change on an individual financial statement line item basis, which can take a significant amount of time to determine.

Implementation Challenges

With the complexities of adjusting to the new standard, consider if technology programs can help you identify key contract terms, craft your revenue recognition policies, key documentation needs, and internal control needs. ■

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