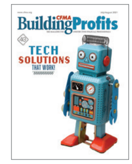

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Topic 606: Classification & Presentation of Retainage & Contract Assets & Liabilities

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers*, was intended to enhance comparability of revenue recognition across all industries.[1] While adopting the new guidance under Topic 606, many in the construction industry discovered that there were often only minor changes in the amount of revenue recognized as compared to the amount recognized using the legacy percentage-of-completion method (PCM) under ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*.

While some circumstances do result in more significant differences, many in the construction industry experienced little or no material impact to the amount of revenue previously recognized as a result of adopting Topic 606. However, while Topic 606 focused primarily on revenue recognition, it also impacted two additional key areas of the balance sheet:

1) Classification of retainage

2) Contract assets and contract liabilities

Classification of Retainage

In long-term construction contracts, retention provisions are common – generally as a form of security by which the customer withholds a portion of the consideration billed by the contractor for work completed until certain construction milestones are reached or the project itself is completed. Retainage provides a financial incentive to help ensure the contractor completes their work appropriately and in accordance with the contract terms.

Prior to the adoption of Topic 606, retainage was typically classified by many contractors as a receivable; however, in addition to the significant focus of Topic 606 on how much and when to recognize revenue, it also clearly states in ASC 606-10-45-4 that "a receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due."

On the other hand, Topic 606 defines a contract asset as "an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance)."

Accordingly, to determine proper classification of retainage, it's critical to determine if the right to consideration is conditional or unconditional upon something other than the passage of time.

Careful evaluation is required in determining whether retainage should be classified as a receivable or as a part of the related contract's asset (or netted with the related contract's liability when the contract is in a liability position). In long-term construction contracts, retainage is generally subject to conditions other than the passage of time, such as:

- The completion of future obligations under the contract
- Meeting certain milestones
- Performance metrics

In these situations, retainage shouldn't be classified as a receivable as it is subject to conditions "other than the passage of time" and should be included in the contract asset or contract liability, which is determined at the individual contract level.

While under certain circumstances it may be appropriate to classify retainage as a receivable, this will be limited to situations in which the right to payment of retainage is solely contingent upon the passage of time. Generally, this is appropriate after the conditions upon which the retainage was contingent have been satisfied and before the customer has paid the retained amount.

In making this determination, it's critical to carefully assess the contract terms and legal provisions. When concluding retainage represents an unconditional right to payment, it's recommended to consult with your legal advisors to ensure that the contract's terms and provisions have been evaluated appropriately and the retained amount isn't contingent upon anything except the passage of time. This evidence of a thorough analysis and potentially a legal opinion may be necessary to support a company's classification of retainage as a receivable.

Additionally, when retainage is believed to be meeting the requirements to be classified as a receivable (not conditional upon anything but the passage of time), consideration should be given to whether the retainage payment provisions result in a significant financing component in the contract, as described in paragraphs 15 through 20 of ASC 606-10-32 and further discussed in the section titled "Other Considerations."

Financial Statement Presentation Overview

Contract asset and contract liability positions should be determined on a net basis at the individual contract level and not at the performance obligation level, which is where the amount of revenue recognition is determined. This means that a company should net each position in a contract so that an individual contract is included entirely in either the *contract asset* or the *contract liability* section – but not both – on the balance sheet.

Contract Asset

A *contract asset* represents a company's right to consideration in exchange for goods or services that a company has transferred to the customer. A contract asset should be recorded when a company has transferred goods or services to the customer prior to receiving consideration and when payment of consideration is contingent upon anything other than the passage of time (e.g., future performance by the company).[2]

Contract Liability

A *contract liability* represents a company's obligation to transfer goods or services to a customer. A contract liability should be recorded, prior to the transfer of the good or service to the customer, when a company has received consideration or when the company has a right to an amount of consideration that is unconditional.[3]

Accounting Policy

It's common in the construction industry to have an operating cycle that extends beyond 12 months. While the guidance in Topic 606 requires the net contract asset or contract liability balance to be bifurcated between current and noncurrent if the company presents a classified balance sheet, many in the construction industry have elected and disclosed an accounting policy to classify all contract-related assets and liabilities as current due to their operating cycle commonly extending beyond 12 months.[4]

Such an accounting policy follows more specific guidance for the classification as current vs. long term for other assets and liabilities, which is further described in Chapter 6 of the AICPA's *Audit and Accounting Guide: Construction Contractors* and is consistent with guidance in Topic 210 – *Balance Sheet.*[5]

Terminology Shift

While the guidance in Topic 606 uses the terms *contract asset* and *contract liability*, the guidance doesn't prohibit the use of alternative descriptions in financial statements. If alternative descriptions are used, it's required that sufficient information is provided for users of the financial statements to distinguish between receivables and contract assets.[6]

ASC 605-35: Alternative B

Under legacy generally accepted accounting principles (GAAP), unbilled revenue – or the near equivalent of Topic 606's contract asset – was commonly referred to in financial statements as *costs and estimated earnings in excess of billings on uncompleted contracts*, and deferred revenue – or the near equivalent of Topic 606's contract liability – was commonly referred to as *billings in excess of costs and estimated earnings on uncompleted contracts.* This terminology was closely aligned with the PCM of recognizing revenue under Alternative B of ASC 605-35-25 paragraph 84, where revenue recognition was calculated as displayed in Exhibit 1.

As seen from the first of the two equations in Exhibit 1, Alternative B adds together costs and estimated earnings to arrive at revenue. This is where the costs and estimated earnings portion of *costs and estimated earnings in excess of billings on uncompleted contracts* and *billings in excess of costs and estimated earnings on uncompleted contracts* comes from.

Determining Revenue Under Topic 606

However, Alternative B from ASC 605-35-25 isn't consistent with the process of recognizing revenue under Topic 606, which states that revenue should be recognized when or as a company satisfies a performance obligation. While there are various methods that may be used to determine progress toward satisfaction of a performance obligation when recognizing revenue over time, the cost-to-cost input method (ASC 606-10-55-20) is commonly used for long-term construction

Exhibit 1: ASC 605-35 Alternative B Equations

Revenue recognized during the period = Costs incurred on the contract during the period + Gross profit earned during the period

Gross profit earned during the period = [Total estimated gross profit on the contract as a whole x Percentage of completion] – Gross profit recognized in prior periods

Exhibit 2: Determining Revenue Under Topic 606

Revenue recognized during the period = [Consideration allocated to the performance obligation x Percentage of completion] – Revenue recognized in prior periods

Exhibit 3: Alternative Terminology for Contract Asset & Contract Liability

Contract Asset	Contract Liability
Contracts in progress	Contracts in progress
Work-in-progress	Work-in-progress
Revenue earned in excess of amounts received or receivable	Payments received or receivable in excess of revenues earned
	Deferred revenue

contracts. Under this method, the key inputs are the total estimated transaction price allocated to the performance obligation, total estimated costs of the performance obligation(s), and actual cost incurred representing progress toward completion of the performance obligation.

Regardless of the method used to measure progress toward satisfaction of a performance obligation, Topic 606 doesn't include a concept of recognizing revenue based on the amount of gross profit earned on a contract for a period plus the costs incurred on the contract during the period in the manner that legacy GAAP did. Instead, Topic 606 determines revenue as shown in Exhibit 2.

Additionally, under legacy GAAP, the amount classified as *costs and estimated earnings in excess of billings on uncompleted contracts* generally excluded retainage, regardless of whether the retainage was subject to conditions other than the passage of time or not. Generally, retainage associated with amounts being billed was reflected on the progress billings presented to the customer and recorded as a receivable. Accordingly, since *billings* is a term that doesn't clearly indicate whether the amount includes more than just receivables – a company's right to consideration subject only to the passage of time under Topic 606 – it can create confusion and is not recommended for describing a company's contract asset or contract liability.

Transitioning to New Terminology

Due to the elimination of ASC 605-35's Alternative B approach to revenue recognition, the introduction of the clearly understood terminology of *contract assets* and *contract liabilities* in Topic 606 and the change resulting from the more restrictive definition of a *receivable* (which results in retainage subject to more than just the passage of time being included in the contract's asset or liability), it is recommended that companies transition from using the phrase *costs and estimated earnings in excess of billings* and *billings in excess of costs and estimated earnings* when describing their contract assets and contract liabilities.[7]

Within the construction industry and across nearly all industries, simply using *contract assets* and *contract liabilities* to describe such amounts on a company's balance sheet is the most clearly understood description. Now that we're well past the transition to Topic 606, using other terms to describe such amounts may create more confusion for financial statement users than it might clarify. However, if a company desires to use terms other than contract assets and contract liabilities, Exhibit 3 on page 66 presents a few alternatives considered acceptable by many.

Presentation Examples

There's some flexibility with how to present and disclose retainage, receivables, contract assets, and contract liabilities in a company's financial statements in accordance with Topic 606. The following are a couple of options we've seen that provide the desired transparency for financial statement users in the construction industry. Exhibit 4 on page 70 provides significant information about retainage on the face of the balance sheet, while Exhibit 5 on page 71 provides more detailed information in the footnotes.

Other Considerations

Significant Financing Component

Companies will need to consider whether a significant financing component exists when retainage is classified as a receivable, which is when retainage isn't contingent on anything other than the passage of time.

Topic 606 requires the transaction price to be adjusted for the effect of the time value of money if the timing of payments provides the company or the customer with a significant benefit of financing the transfer of goods or services. When a company provides goods or services prior to the customer paying for them, the existence of a significant financing component would result in the company recognizing interest income since the company is providing the financing to the customer. The transaction price would be reduced by the interest income to ensure the amount recognized as revenue reflects the cash selling price that the customer would have paid at the time at which the goods or services were transferred.

For example, let's say a contract provides the customer with a lower overall price if the customer makes progress payments as the performance obligation is satisfied over the term of the contract – compared to the customer paying upon completion of the project – then there may be a financing component that requires further analysis.

In comparison, when the customer pays for the goods or services prior to the company providing them, the existence of a significant financing component would result in the company recognizing interest expense as the customer is providing the financing to the company. The transaction price and revenue recognized under this scenario would be the combined amount that the customer paid upfront, plus the amount of interest expense recognized over the period between a customer's initial payment and satisfaction of the performance obligation.

When adjusting the transaction price for a significant financing component, the discount rate used should be the same as what would be used if the company and customer entered into a separate financing transaction.

For example, this may occur when a contractor receives an advance payment from the customer that's intended to provide the contractor with operating cash flows to finance the project. This would exclude advance payments for the purchase of raw materials and other resources to be used in the project.

A significant financing component may exist regardless of whether the promise of financing is stated in the contract or implied by the payment terms. When assessing whether a contract contains a significant financing component, it's important to consider all relevant facts and circumstances, in addition to:

- The expected length of time between when the goods or services are transferred and when the customer pays for those goods or services; and
- The prevailing interest rates in the relevant market.

In contrast, a significant financing component doesn't typically exist for retainage that's contingent upon something other than the passage of time and classified within the contract's asset or netted with the contract's liability. This is because such retainage is generally payable only upon successful completion of the contract or upon achievement of a specified milestone, performance metrics, etc.

Standard retention provisions in many construction contracts are generally intended to protect the customer from the contractor failing to complete the project in accordance with the terms of the contract, rather than to provide the customer with a significant benefit of financing. In paragraphs 233-234 of ASC 606-10-55 – ***Withheld Payments on a Long-Term Contract*** – it is further illustrated that retentions to protect

Exhibit 4: **Retainage Detail on the Balance Sheet**

Current Assets Excerpt from the Balance Sheet	20X1	20X0
Cash and cash equivalents	$ X,XXX	$ X,XXX
Investments	XXX	XXX
Contracts receivable, including unconditional retainage* of $XXX and $XXX at December 31, 20X1, and 20X0, respectively	XX,XXX	XX,XXX
Contract assets, including conditional retainage** of $X,XXX and $X,XXX at December 31, 20X1, and 20X0, respectively	XXX,XXX	XXX,XXX
Prepaid expenses	XXX	XXX
TOTAL CURRENT ASSETS	$XXX,XXX	$XXX,XXX

Current Liabilities Excerpt from the Balance Sheet	20X1	20X0
Accounts payable and accrued expenses, including $XXX and $XXX of subcontractor retainage payable at December 31, 20X1, and 20X0, respectively	$ XX,XXX	$ XX,XXX
Contract liabilities net of conditional retainage** of $X,XXX and $X,XXX at December 31, 20X1, and 20X0, respectively	XXX,XXX	XXX,XXX
Accrued losses on uncompleted contracts	XXX	XXX
Current maturities of long-term debt	X,XXX	X,XXX
TOTAL CURRENT LIABILITIES	$XXX,XXX	$XXX,XXX

**the right of payment for retainage is solely contingent upon the passage of time*
***the right of payment for retainage is subject to conditions other than the passage of time*

Excerpt of Summary of Significant Accounting Policies Footnote

Contracts Receivable

Contracts receivable are recorded on construction contracts and include billed and unbilled amounts for services provided to customers for which the company has an unconditional right to payment.

Billed and unbilled amounts for which payment is contingent on anything other than the passage of time are included in contract assets and contract liabilities on a net basis at the individual contract level.

Retainage for which the company has an unconditional right to payment that is only subject to the passage of time is included in contracts receivable. Management evaluates the collectability of its receivables on a continuous basis and has determined that no allowance for doubtful accounts was necessary at December 31, 20X1, and 20X0.

Contract Assets & Contract Liabilities

The amounts included within contract assets and contract liabilities are related to the company's long-term construction contracts. Retainage for which the company has an unconditional right to payment that is only subject to the passage of time is classified as contracts receivable. Retainage that is subject to conditions other than the passage of time is included in contract assets and contract liabilities on a net basis at the individual contract level.

Contract assets represent revenue recognized in excess of amounts paid or payable (contacts receivable) to the company on uncompleted contracts. Contract liabilities represent the company's obligation to perform on uncompleted contracts with customers for which the company has received payment or for which contracts receivable are outstanding.

Exhibit 5: **Retainage Detail in Footnote Disclosures**

Current Assets Excerpt from the Balance Sheet	20X1	20X0
Cash and cash equivalents	$ X,XXX	$ X,XXX
Investments	XXX	XXX
Contracts receivable	XX,XXX	XX,XXX
Contract assets	XXX,XXX	XXX,XXX
Prepaid expenses	XXX	XXX
TOTAL CURRENT ASSETS	$XXX,XXX	$XXX,XXX

Current Liabilities Excerpt from the Balance Sheet	20X1	20X0
Accounts payable and accrued expenses	$ XX,XXX	$ XX,XXX
Contract liabilities, net of conditional retainage	XXX,XXX	XXX,XXX
Accrued losses on uncompleted contracts	XXX	XXX
Current maturities of long-term debt	X,XXX	X,XXX
TOTAL CURRENT LIABILITIES	$XXX,XXX	$XXX,XXX

Excerpt of Summary of Significant Accounting Policies Footnote

Contracts Receivable

Contracts receivable are recorded on construction contracts and include billed and unbilled amounts for services provided to customers for which the company has an unconditional right to payment. Billed and unbilled amounts for which payment is contingent on anything other than the passage of time are included in contract assets and contract liabilities on a net basis at the individual contract level.

Retainage for which the company has an unconditional right to payment that is only subject to the passage of time is included in contracts receivable and amounted to $XXX and $XXX at December 31, 20X1, and 20X0, respectively. Management evaluates the collectability of its receivables on a continuous basis and has determined that no allowance for doubtful accounts was necessary at December 31, 20X1, and 20X0.

Contract Assets & Contract Liabilities

The amounts included within contract assets and contract liabilities are related to the company's long-term construction contracts. Retainage for which the company has an unconditional right to payment that is only subject to the passage of time is classified as contracts receivable. Retainage subject to conditions other than the passage of time are included in contract assets and contract liabilities on a net basis at the individual contract level.

Contract assets represent revenue recognized in excess of amounts paid or payable (contracts receivable) to the company on uncompleted contracts. Contract liabilities represent the company's obligation to perform on uncompleted contracts with customers for which the company has received payment or for which contracts receivable are outstanding.

The following table provides information about contract assets and contract liabilities from contracts with customers as of December 31, 20X1, and 20X0.

Contract Assets	20X1	20X0
Revenue recognized in excess of amounts paid or payable (contracts receivable) to the company on uncompleted contracts (contract asset), excluding retainage	$XXX,XXX	$XXX,XXX
Retainage included in contract assets due to being conditional on something other than solely passage of time	XXX	XXX
TOTAL CURRENT ASSETS	$XXX,XXX	$XXX,XXX

Contract Liabilities	20X1	20X0
Payments received or receivable (contracts receivable) in excess of revenue recognized on uncompleted contracts (contract liability), excluding retainage	$XXX,XXX	$XXX,XXX
Retainage included in contract liabilities due to being conditional on something other than solely passage of time	X,XXX	X,XXX
TOTAL CONTRACT LIABILITIES	$XXX,XXX	$XXX,XXX

the customer from the contractor failing to complete the project in accordance with the contract terms isn't a significant financing component.

Topic 606 also provides a practical expedient, whereby a company may choose to only consider whether a significant financing component exists for situations in which, at contract inception, the company expects the period of time between the transfer of goods or services and the related payment to be greater than 12 months.

Performance Metrics, Debt Covenants & Borrowing Base Limits

The classification of retainage may impact performance metrics, debt covenants, and borrowing base determinations for revolving lines of credit.

It's common for debt agreements to contain financial covenants based on performance metrics reliant on GAAP financial inputs. It's important to review such debt agreements to determine how the classification of retainage will affect your company's ability to meet its debt covenants or other contractual commitments.

Similarly, a company's line of credit may include a borrowing base limit, and the classification of retainage may impact the amount available to the company under the line of credit agreement. Receivables are typically included in the borrowing base calculations, while contract assets generally are not.

After reviewing existing debt agreements and covenant requirements to determine the impact of the classification requirements of Topic 606 and any changes to terminology for contract assets and contract liabilities, it's recommended to have a dialogue with creditors about how these accounting changes can be addressed.

It's important for the financial statement users to understand the difference in classification of retainage included as a receivable as opposed to retainage included within a contract asset or contract liability. Doing so will help to determine if adjustments to the covenants, borrowing base, or other financing agreement can be made to prevent a company from being negatively impacted by the implementation of Topic 606 when the underlying economics of the contractor's business haven't changed. ■

Endnotes

1. "Revenue from Contracts with Customers (Topic 606)." Financial Accounting Standards Board. May 2014. *asc.fasb.org/imageRoot/00/51801400.pdf*.
2. Ibid.
3. Ibid.
4. "Audit and Accounting Guide: Construction Contractors." American Institute of CPAs. 2020.
5. FASB ASC Topic 210-10-45-3.
6. FASB ASC Topic 606-10-45-5.
7. "Construction Contractors Revised Sample Financial Statements: Appendix H" (Exposure Draft). American Institute of CPAs. May 10, 2021. *aicpa.org/content/dam/aicpa/research/exposuredrafts/accountingandauditing/downloadabledocuments/20200827a/aicpa-aag-con-exposure-may-10-2021.pdf*.

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