Implementing Revenue Recognition Through the Eyes of the Contractor

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Speaker

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A graduate of Villanova University Tony is a frequent presenter at the AICPA, PICPA, CFMA , AGC/CFMA, ABC, NECA and CICPAC Annual Construction Conferences. He also writes articles for CFMA Building Profits publication. Tony is a founding member of CFMA's Philadelphia Chapter and the Construction Industry CPA Consultants Association (CICPAC).

Tony has chaired CFMA's Education and Accounting and Reporting Committees. He is past CFMA national Secretary and Executive Committee member. Tony is a recipient of CFMA's national; Debra Hahn Memorial Award , Danny B. Parrish Outstanding Leadership Award, the Joe Quigley Memorial Award, the ICCIFP Founders Award and the CFMA Mid-Atlantic – Anthony R. Stagliano Leade4rship Award. Tony has co-chaired the CCIFP Examination Development Committee for several years and he co-authored the all day CCIFP Overview course.

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Speaker

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John has been in the Construction Industry for his entire career, 26 years with 2 public accounting firms that had groups of professionals dedicated to serving Contractors and Real Estate Developers, most recently as a Director with CBIZ & Mayer Hoffman McCann P.C. John has served as CFO for 2 contractors, including 5 years with a heavy highway contractor in the Philadelphia market and the past 8 years with National Glass.

He graduated in 1980 from Villanova University with a B.S. in Accounting. John has been an active member of CFMA's Philadelphia Chapter since 1989 and has served on numerous committees and Boards on both a local and national level, including President of the Philadelphia Chapter from April of 2014 through March of 2016. John has also served on the CCIFP Exam Development Committee, which is charged with preparing the exam questions. John has been involved for many years on the Steering and Program committees for the CFMA Mid-Atlantic Conference.

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Session

- **Description**

  Charting a Course through the **Murky Waters** of the New Revenue Recognition Standard **(Rev Rec),** as it relates to Construction Companies is **not for the faint of heart**. CPA's in public practice are attempting to learn the nuances of the soon to be effective new standard on **Revenue From Contracts With Customers** as it applies to their non-public contractor clients.

  However it's the **Contractor** who is on **the front-line/trenches** who is **ultimately responsible** for implementing the standard. Plus, the contractors CFM needs to explain it to their owners, PM's and estimators; what it is, what it's for and how that information impacts the job cost accounting and financial reporting. Therefore, come listen to a Contractors CFM and construction CPA for a common sense approach to the implementation of Revenue Recognition from the contractor's perspective.

- **Learning objectives**

  Learn from experienced professionals in construction and public accounting about how to evaluate the practical interpretations for; identifying performance obligations, variable considerations, contract modifications, transfer of control, acceptable measures of progress, contract costs, uninstalled materials, disclosures and the pros and cons of early adoption for non-public contractors to mention a few.

Todays Program Presentation Overview

Meeting between John (Contractor) and Tony (John's CPA)

- Audience will play the role of <u>a contractor</u>
- This meeting is necessary pre-audit/review planning that will be an additional procedure to the normal year end engagement fee and I think you will see why soon
- We will **<u>NOT</u>** resolve all issues here today
  - Mainly because Topic 606 must be interpreted by and for each individual contractor
- **Questions are welcome**
- Acronyms:
  - GAAP – Generally Accepted Accounting Principals
  - FASB – Financial Accounting Standards Board
    - ASC - Accounting Standards Codification
      - A *code* is a collection of laws arranged in an orderly way
    - ASU – Auditing Standard Updates
  - FinREC — Financial Reporting Executive Committee
  - PCC – Private Company Council
    - FAF – Financial Reporting Framework
    - SME – Small and Medium-size Entities
  - TRG – Transition Resource Group
- <u>Contractors must understand and implement this new standard **NOT** their CPA</u>
  - FASB Accounting Standards Codification (ASC) 606/Topic 606
- There is a whole new vocabulary
- 2018/2019 are the first years for implementation and there will be some **<u>unintended consequences</u>**

Presentation Overview – Rev. Rec.

- Topic 606 “Revenue from Contracts With Customers”
  - This is possibly the largest and most comprehensive accounting pronouncement ever on top of the largest change in the tax code since 1986
  - Some possible misconceptions
    - Do nothing because it doesn’t apply to our company
    - FRF for SME’s & OCBOA will avoid compliance with the new standard
  - Impact to your company **may not be <u>significant</u>** if at all
  - Consequences of not being prepared
  - Principals-based Vs. Rules-based
  - ASC Topic 606 is for all industries/professions/businesses with contracts with customers
  - **<u>Significant</u>** judgements
    - Methods used to allocate transaction price
    - Key **<u>judgements</u>** as well as changes in those judgements
    - Methods for measuring progress
    - Assessing the amount of variable consideration includable in the transaction price

Resources for Guidance

- Financial Accounting Standards Series
  - FASB Accounting Standards Update
    - Revenue from Contracts with Contractors (Topic 606)
      - **No. 2014-09 / May 2014**
    - The FASB also issued the following amendments to ASU No. 2014-09 to provide clarification on the guidance:
      - No. 2016-08 / March 2016
      - No. 2016-10 / April 2016
      - No. 2016-12 / May 2016
      - No. 2016-20 / December 2016

Resources for Guidance

- **2018 AICPA, Audit & Accounting Guide – Revenue Recognition**
  - Chapter 11, Engineering and Construction Contractors
    - Pages 487 - 519
- **AICPA – Construction Contractors: Audit and Accounting Guide July 1, 2018**
  - AICPA Member: $89.00
  - Non-Member: $109.00
- **CFMA Revenue Recognition Implementation Guide**
  - CFMA.org
    - Publications & Resources, Revenue Recognition Implementation Guide
      - Price: $75.00
        Member Price: **$25.00**
- **CICPAC Revenue Recognition Implementation Guide**
  - CICPAC.com
    - Resources tab, then click Revenue Recognition Guide, then click Download

New Revenue Recognition Standard – Five-Step Model

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

Developing a plan

- This will include choosing a team leader (most likely the CFO/controller), identifying any software changes needed to accommodate the new standard, making it available to the required users, and <u>educating them on what needs to happen</u>.
- It also means determining the approach to your company's different niches, lines of business, and contract types. They each may be treated differently under Topic 606.
- Begin with a couple people (Controller, PM) and a couple contracts, then expand to the entire company from there.

Assemble a team

- Create an internal cross-function team – clerical to owners
  - Assemble a task force and identify a leader (Controller/CFO)
  - Develop your understanding of the new standard
  - Identify your typical types of contracts and related revenue streams
  - Evaluate the impact of the new standard will have on each type of contract/revenue stream
  - Evaluate the impact the new standard will have on operations as well as accounting
- Team representation from -
  - Finance and accounting
  - IT
  - Legal
  - Estimation/Project Management
  - Executive Management

First Things First

RTFC's

Know your contract clauses

- Especially your normal contract types
  - Deep dive into the company’s contracts
- Create a decision tree/Checklist
- To be completed for each new contract that ***supports the ultimate conclusions (documentation)***
- Termination for convenience
- Warranty provisions
- Variable pricing clauses
- Price escalation
- Economic price adjustments
- Payment and volume discounts and rebates

Contract Provisions

Checklist –

- Who is responsible for reviewing and excerpting important contract clauses? **(<u>Contract Abstract</u>)**
    - Job number
    - Type of contract
    - Location and description of the project
    - Contract amount
    - Original cost estimates and related gross profit
    - Billing and Retention terms
    - Pay when paid clause
    - Pay if paid clause
    - Stored materials
    - Uninstalled materials
    - Design/build
    - Mobilization
    - Bonding & insurance requirements
    - Owner or Contractor controlled insurance program (OCIP/CCIP)
    - Shared savings
    - Refunds/rebates

Get comfortable with new terms/vocabulary/concepts

- **Transaction price** – (Contract amount)
  - Is the amount of **consideration** to which an **entity** expects to be entitled to in exchange for transferring promised goods or services
  - Factors that must be considered in determining total estimated revenue includes:
    - a) The basic contract price
    - b) Contract options
    - c) Change orders (+ -) and
    - d) Contract provisions for penalty and incentive payments including award fees and performance incentives
- **Variable consideration**
  - Change orders (including unpriced CO's), claims, back charges, extras, and contract provisions for discounts, rebates, penalty and incentive payments, including award and performance incentives (See ASC 606 paragraphs 10-25-10 to 10-25-13)
    - only to the extent that it is **probable** that a **significant reversal** in the amount of cumulative revenue recognized **will not occur** when the uncertainty associated with the variable consideration is subsequently resolved.
- **Probable**
  - For "probable" GAAP utilizes a 70-80% likelihood of occurrence.
- **Constraining Estimates of Variable Consideration**
  - An entity is required to evaluate the likelihood and magnitude of a reversal of revenue due to a subsequent change in the estimate (See FASB ASC 606-10-32-11)
  - Updating estimates of variable consideration is required (See FASB ASC 606-10-32-14)
    - If needed – Cumulative catch-up adjustment

Get comfortable with new terms/vocabulary/concepts

- **<u>Estimation of Variable Consideration</u>**
  - Two methods for estimating variable consideration (see FASB ASC 606-10-32-8)
    1. The expected value method
       - Based on the sum of probability-weighted amounts in a range of possible **consideration** amounts
    2. The most likely amount
       1. Based on the single most likely amount in a range of possible **consideration** amounts
       2. Method may be appropriate if the estimate has only two possible outcomes
          1. All or none
- **Contract <u>Modification</u>**
  - FASB ASC 606-10-25-10 through 25-13
  - Management control of change orders, claims, extras, and back charges is of critical significance in construction activity.
  - Modifications of the original contract frequently result from change orders that may be initiated by either the customer or the contractor. The nature of the construction industry, particularly the complexity of some types of projects, is conducive to disputes between the parties that may give rise to claims or back charges.
  - Is a change in scope, price or both
  - Could be a separate contract if –
    - The addition of promised goods or services are **<u>distinct</u>**
    - The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods services

Get comfortable with new terms/vocabulary/concepts

- **Performance obligation** –
  - **FASB ASC 606-25-14**
    - Is a promise in a contract with a customer to transfer a **Distinct** good or service
  - **FASB ASC 606-25-15**
    - Recognition of revenue related to the transfer of goods or services to customers
- **Distinct** Good or Service (Bundle/Series) – a matter of **judgement**
  - **FASB ASC 606-10-18 to 22**
  - **Customer** can benefit from that good or service either on its own or with readily available resources or those available to the customer in the market place.
  - Requires the contractor to evaluate whether the promised good or service in the contract is separately identifiable from other **promises** in the contract (that is the promise **to transfer the good or service** is **distinct** within the context of the contract).
    - Evaluate the criteria in FASB ASC 606-10-25-19(b) – Whether those goods or services are distinct within the context of the contract
- **Multiple Performance Obligations**
  - When multiple performance obligations (**distinct** goods and services) are present within a contract, the standard requires the transaction price (overall contract value) be allocated to the separate performance obligations
    - Most commonly due to the contract covering multiple phases of a project (design, construction, operational management and maintenance)
- Continuous transfer of control of the **deliverable** to the customer

Get comfortable with new terms/vocabulary/concepts

- **Contract asset**
  - Entities are required to use the term “Contract Asset” for capitalized costs and must disclose information to the users of the financial statements to support the right to receive **consideration** for the contract asset
  - Classification of the contract asset as current or noncurrent will be dependent on the timing of the expected recovery
  - Represent revenues recognized in excess of amounts billed for fixed price contracts and are current assets that are transferred to accounts receivable when billed or the billing rights become **unconditional**
- **Unconditional right to receive**
  - Collectible when billed with no additional performance obligation required except for the passage of time
- **Contract liability**
  - Represents billings in excess of revenues recognized for fixed price contracts. Contract liabilities are current liabilities.
- **Practical expedients** and exceptions
  - Example – Modified retrospective transition method
    - Allows the new guidance to be applied only to contracts that were not considered substantially completed as of January 1, 2019

Get comfortable with new terms/vocabulary/concepts

- <u>**Retainage**</u>
  - Under the current standards, retainage is considered a contract receivable as the project progresses. The New Guidance requires retainage to be included in <u>**contract assets and liabilities**</u> until all of the performance requirements are completed by the entity. Once retainage is conditional based only on the passage of time, retainage will be reclassified to a receivable or payable from contract asset or liability.
  - If receivables include amounts representing balances billed but not paid by customers under contract retainage provisions, FASB ASC 910-310-50-4 states that <u>**a contractor should disclose, either in the balance sheet or in a note to the financial statements**</u>, all of the following:
    - The amounts
    - The portion, if any, <u>**expected to be collected after one year**</u>
    - If practicable, the years in which the amounts are expected to be collected
  - Regarding certain liabilities common to construction contractors, **FASB ASC 910-405-50-1** states information relating to accounts and retentions payable should be disclosed, including the <u>**amounts of retentions to be paid after one year**</u> and, if practicable, the year in which the amounts are expected to be paid.
- <u>**Unconditional right**</u> **to receive**
  - Collectible when billed with no additional performance obligation required except for the passage of time

Get comfortable with new terms/vocabulary/concepts

- **<u>Precontract</u> costs (FASB ASC 605-35-25-41)**
  - Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained should not be included in contract costs or inventory before the receipt of the contract.
  - Such costs otherwise may be deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from the contract is probable.
  - Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.
  - Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.
  - Costs appropriately deferred in anticipation of a contract should be included in contract costs on the receipt of the anticipated contract.
  - Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered probable should not be reinstated by a credit to income on the subsequent receipt of the contract.
  - Engineering, design, Start-up, mobilization, or other services performed on the basis of commitments or other such indications of interest
    - They might qualify as **<u>precontract costs</u>** but not **<u>incremental cost</u>** to obtain the contract.

Get comfortable with new terms/vocabulary/concepts

- **Incremental costs of obtaining a contract** (FASB ASC 340-40-25-1& 2)
  - **Are they Significant?**
  - These costs **would NOT** have been incurred if the contract had not been awarded to the contractor
  - These costs are to be capitalized on the balance sheet and then amortized on a basis consistent with the transfer of the goods or services to which the amounts relate
  - Transition Resource Group (TRG)
    - Costs incurred immediately prior to signing the contract would not meet this definition
  - Examples:
    - Sales commissions paid to sales personnel
    - Bond cost
    - Licenses
    - Permits
    - Legal fees
  - **Practical expedient** – (FASB ASC 340-40-25-4)
    - **An entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less**

Get comfortable with new terms/vocabulary/concepts

- **Fulfillment costs (**FASB ASC 340-40-25-5)
  - Costs that relate to a contract such as materials and labor.
  - The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
  - The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
  - The costs are expected to be recovered **are eligible for capitalization**
- **Capitalized Costs**
  - **Establish a mechanism to accumulate all costs associated with a potential contract**
    - **Separate pre-job #, Spreadsheet, separate G/L account**
    - **Once awarded a designated person from accounting and the project manager should review the costs to determine if they meet the definition of the categories**
      - **Incremental costs to obtain the contract**
      - **Fulfilment costs**
      - **Expense**
    - **The determination is documented so the accounting can properly record it in the general ledger**
- **Onerous contracts**
  - Loss job/contract
  - 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 performance obligations and one of those performance obligations will result in a loss for that 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.

Get comfortable with new terms/vocabulary/concepts

- **Transition Methods/Approach** – footnote disclosure
  - **Modified retrospective** – (Prediction - majority of contractors will be using this method)
    - The entity can elect to apply this standard retrospectively only to contracts that have not been completed at the date of initial application
      - January1, 2019 for an entity with a December 31 year-end
  - **Retrospective**
    - The entity can elect to apply this standard retrospectively to all contracts at the date of initial application
  - Accounting/reporting under either method above
    - The adjustment will also include any adjustments relating to unamortized costs to obtain contracts, capitalized fulfillment costs, etc.
    - A cumulative catch-up adjustment to retained earnings as of the date of the initial application (January 1, 2019)
    - The comparative 2018 statement would not be restated

New Revenue Recognition Standard – Five-Step Model

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.

Step One – Identify the Contract

Contract Modifications

- The new guidance defines a contract modification as "…a change in scope or price (or both) of a contract that is approved by the parties…"
  - Accounting for change orders under the new guidance is more complex than it is under existing GAAP.
- C/O are added to the contract when it's probable the amount will be approved and can be estimated (70% - 80% likelihood). Similar to previous GAAP.
- New guidance will require management to determine if the modification should be accounted for as a separate contract.
- If change order is not ***distinct*** from the existing contract, it is accounted for as a cumulative catch up.
  - If **distinct**, accounted for as a separate contract.

Step One – Identify the Contract

Contract Modifications

- In order to include the amount in the contract price, the ***parties need to approve*** the change order, either:
  - In writing
  - Orally
  - Or ***implied by the customary business practice***
- Contract modification will exist when there is an enforceable right or obligation.
- Under the new guidance, revenue recognition should be considered even if the final scope and price have not been determined.
  - Management is required to use estimated pricing if a formal change order has not been finalized.
  - Evaluate history and experience in similar situations.
  - Need to assess collectability of the amount that will be transferred before payment (pending change orders).

Liquidated Damages (expected value method)

- **Contract characteristics:**
  - A contractor enters into a contract with a customer to construct a commercial building for fixed consideration of $10 million.
  - The construction of the building is a single performance obligation that is satisfied over time.
  - The contract requires achievement of substantial completion 104 weeks after receipt of the notice to proceed and assesses $20,000/day in liquidated damages for each day substantial completion exceeds the target.
  - Based on past experience, the contractor incurs liquidated damages on contracts according to the probabilities in the following table.

  - **Note – Bonus / Incentives would be calculated the same as Liquidated Damages**

Liquidated Damages (expected value method)

Possible period of delay		$ LDs/day	Total $ LDs	Probability %	Weighted $ LDs
0 weeks	0	$20,000	$0	50.0%	$0
4 weeks	28	$20,000	$560,000	5.0%	$28,000
8 weeks	56	$20,000	$1,120,000	5.0%	$56,000
12 weeks	84	$20,000	$1,680,000	15.0%	$252,000
16 weeks	112	$20,000	$2,240,000	19.0%	$425,600
20 weeks	140	$20,000	$2,800,000	3.0%	$84,000
26 weeks	182	$20,000	$3,640,000	3.0%	$109,200
				100%	$954,800

At contract inception, the contract value should be constrained based on when the probability of incurring liquidated damages exceeds 70% as follows:

Possible period of delay		$ LDs/day	Total $ LDs	Probability %	Weighted $ LDs
0 weeks	0	$20,000	$0	50.0%	$0
4 weeks	28	$20,000	$560,000	5.0%	$28,000
8 weeks	56	$20,000	$1,120,000	5.0%	$56,000
12 weeks	84	$20,000	$1,680,000	15.0%	$252,000
				75%	$336,000

At inception of the contract, the transaction price would be:
Contract amount ($10 million) - probability weighted liquidated damages ($336,000) = $9.664 million

Step Five – Recognizing Revenue

Uninstalled materials

- Project often requires a wide range of goods to be assembled to produce a combined unit of output (Single performance obligation).
- Material may arrive on the job site or at the shop in advance of the contractor's ability to install.
- Using cost-to-cost method, costs incurred may not be proportionate to the progress to satisfy performance obligation – obtain goods before integrated into the project.
- Contractor should consider whether the inclusion of these uninstalled materials would result in recording revenue prematurely.

Step Five – Recognizing Revenue

Uninstalled materials

- The following criteria if met may indicate a cost incurred is not proportionate to the entity satisfying progress in satisfying the performance obligation:
  - 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; and
  - The entity provides the good from a third party and is not significantly involved in designing and manufacturing the good

- The contractor should recognize revenue from uninstalled materials only to the extent of the costs incurred (zero profit). The costs would be excluded from the cost to cost calculation.

- Need to evaluate at inception and throughout the duration of the contract.

Step Five – Recognizing Revenue

Uninstalled materials

- Item procured to complete a performance obligation may not immediately transfer into the control of the customer -
  - Certain of the costs may qualify as inventory – no control.
  - If the customer obtains control of the goods before installed, they would not be considered inventory.
  - However, if the customer does obtain control but the material is not integrated into the overall project, these costs should be excluded from the measure of progress.
  - Record the uninstalled materials at zero profit (revenue = costs incurred).

Step Five – Recognizing Revenue

Uninstalled materials / Example

	Contract Price	Estimated Gross Profit	Contract Revenue	Costs incurred to date	Gross Profit	Percent Complete
Existing GAAP	**2,000,000**	200,000	333,333	300,000	33,333	16.67%
New Standards	1,800,000	200,000	112,500	100,000	12,500	6.25%
New Standards	200,000	-	200,000	200,000	-	100.00%
	2,000,000	200,000	312,500	300,000	12,500	16.67%

Disclosures

- Disaggregation of revenue – type, location, etc. (Public Companies)
- Performance Obligations
- Transition method
- **<u>If it's true</u>**
  - State that your company has not experienced significant changes to the pattern of revenue recognition for its contracts, the identification of contracts and performance obligations or the measurement of variable consideration. For the year just ended the impact related to the adoption of the new revenue recognition guidance on revenues, contract assets and contract liabilities was immaterial.
- Backlog
  - **<u>Pursuant to the new guidance</u>**, we are required to disclose, as of the end of each interim and annual period, the aggregate amount of remaining performance obligations under contracts with customers. We have historically disclosed our backlog, even though backlog is not a term recognized under US GAAP.
- Tax considerations – Yes!
  - Example - Uninstalled materials

Disclosure requirements expanded

- Existing revenue recognition guidance (Topic 605) grants construction companies some leeway in disclosing contract-related information. For instance, you are currently required to provide only general disclosures about revenue-related accounting policies and customer payments, and some disclosures (like backlog) are optional.
- Topic 606 expands both the qualitative and quantitative contractual details required for contractors to provide in their financial statements. Footnotes must include more information about the nature, timing, amount, and potential uncertainty of revenue and cash flows arising from a company's customer contracts.
- While private companies are exempt from some disclosure requirements, these exemptions are limited. Your outside CPA can help you address what is required, what is optional, and when inclusion of the optional detail would be helpful.

Disclosure requirements expanded

- Qualitative and quantitative
  - Summary of Significant Accounting Policies:
    - Contract Receivables
    - Revenue and Cost Recognition
      - Timing of revenue recognition
      - Significant judgements, and changes in judgements, made in applying the guidance to contracts with customers
    - Disaggregation of revenue – optional
  - Separate Notes:
    - Contracts Receivable
    - Costs and Estimated Gross Profit on Contracts in Progress
    - Contract Backlog (Remaining performance obligations)
  - Reconciliations of contract balances ?

Disclosures

<u>Disclosure requirements</u>

- New ***comprehensive disclosure requirements*** that are expected to provide users of the financial statement with detailed information regarding revenue recognition

  - Revenue disaggregated according to the timing and ***qualitative information about how economic factors*** will affect the nature, amount, timing and uncertainty of revenue and cash flows (such as significant judgments and changes in judgments and assets recognized from costs to obtain or fulfill a contract).

  - The opening and closing balance of receivables, contract assets, contract liabilities from contract with customers, if it is not separately presented or disclosed.

  - An entity shall disclose ***information about its performance obligations*** in contracts with customers:
    - When the entity normally fulfills its performance obligations
    - Any significant payment terms
    - Nature of the promised goods or services

Transition

- The new guidance allows companies to select between two transition methods
  - Full retrospective method
  - Cumulative effect adjustment (simplified approach)
- Full retrospective method
  - A company would restate all periods presented as if they had been accounted for under ASC Topic 606 originally. Comparative periods would be restated.
- Retrospective application with a cumulative effect adjustment (simplified approach) –
  - A company can elect to apply ASC Topic 606 only to contracts that are in progress at the date of initial application and new contracts going forward. The cumulative adjustment to the opening balance sheet will be reflected in retained earnings. Disclosures in the financial statements will be required to explain the differences. Comparative periods would not need to be restated.


THANK YOU

Step One – Identify the Contract

Criteria for Existence of a Contract

- Commercial substance
- Approval and commitment by the parties to satisfying their obligation
- Legal enforceable rights regarding transfer of goods and services
- Identifiable payment terms
- Consideration has probable possibility of collection in exchange for goods or services transferred

  Written agreements typically achieve the five criteria above; however, written contract is not required. Cannot start the revenue process without a "contract"

Step One – Identify the Contract

Termination Provision

- Common in the construction industry that customers have a right to cancel for convenience.
- FASB Rev Rec Transition Resource Group (TRG) recommended that contracts with customer termination provisions should be accounted for the same as contracts with unexercised options when the contact does not include a substantive termination penalty.
- That is, if the termination penalty is not substantive, this may indicate that the contract term is less than the stated contractual period.
- Partial completion of a contract is of little value to the customer and the customer would incur additional costs that are considered akin to termination penalties (for example, costs of shutting down the work, demobilization, storage and handling of uninstalled materials, as well as restart costs if the customer later desires to complete the project).
- Contractor should consider whether those penalties are substantive. This will require judgement

Step One – Identify the Contract

Practical Consideration

- Create a form to assess and document that the change order is or is not distinct
- Educate project individuals
- Create assessment form for documentation of Combined contracts
- Create a contract abstract to identify terms

Step Two – Identify Performance Obligations

Performance Obligation

- A promise in a contract with a customer to transfer a good or service to a customer – ***Explicit or Implied.***
- Contract will have multiple performance obligations if each is considered ***distinct.***
- Performance obligations are identified at contract inception and determined based on
  - Contractual terms
  - Customary business practice
- Identifying performance obligations and how they are satisfied will directly affect when revenue is recognized.

Step Two – Identify Performance Obligations

Performance Obligation

Capable of Being Distinct –

- If the customer can benefit from the good or service on its own or together with other resources readily available to the customer (OR)
- Customer can use good or service with other readily available resources

AND Distinct within the Contract

- The good or service is **NOT** integrated with, highly dependent on, highly interrelated with other promised goods or services (OR)
- The good or service does **NOT** significantly modify other promised goods or services in the contract

Step Two – Identify Performance Obligations

Performance Obligation

- Goods or services that are not distinct should be combined with other promised goods or services until the entity has a **bundle** of **goods or services** that can be considered distinct.
- Service is NOT considered separable from other promises in the contract when the company provides an integration service to incorporate services into a combined output.
- **Not distinct** = provide an integration service to manage and coordinate the various tasks AND to assume the risk associated with the integration of the task.
- Contracts for engineering, procurement and construction or design build projects have multiple services that must be evaluated to determine if the good or services represent multiple performance obligations.
- Operation and maintenance is most often a separate performance obligation from design / construction.

Step Two – Identify Performance Obligations

Example #1

A company enters into a contract to design and build an airport terminal. The company is responsible for the design and management of the project, including engineering, site clearance, foundation, procurement, construction of terminal space, airline office space and installation of equipment and finishing. As all of these goods are ***interdependent and interrelated*** (the customer cannot benefit from each good on its own), the contract would be considered **one** performance obligation.

Step Two – Identify Performance Obligations

Example #2

A contractor enters into a contract to manufacture and **install windows.** The contract also includes a provision to provide maintenance on the windows for a period of time. Questions to consider regarding multiple performance obligations:

- Does the contractor regularly manufacture windows for sale without installation?
- Can the customer utilize the windows without the installation?
- Does the contractor provide maintenance services without the installation? Is the maintenance required for the installation?

Step Two – Identify Performance Obligations

<u>Practical Considerations</u>

- Identify different types of contracts based on services provided. Create a "Contract Abstract" form with standard information.
  - Refer to abstract during revenue calculation process
  - Code the job based on contract for identification of possible performance obligations.
- Review contract terms for items that could be considered Distinct Performance Obligation.
  - Customer acknowledges that the services are highly dependent on other services provided.
  - Determine the party that assumes the risk.
  - Consider modification to contract language - Include wording that indicates the service significantly modifies or customizes another service promised in the contract.
- Need to create multiple profit centers for tracking costs if more than one Performance Obligation is identified per contract.
- Revenue recognition based on Contract "type" identified in preparation of contract abstract
  - Implement a control process to "audit" the completion of the Contract Abstract and conclude regarding multiple performance obligations.

Step Three – Determine the Transaction Price

- Transaction price is the amount of consideration a contractor expects to be entitled to in exchange for its performance obligation.
- Typically the stated contract price in the contract .
- Items to consider
  - Contract price
  - Customary business practice
  - Variable consideration
- Amounts are only included in the contract price if it is ***probable*** that a significant reversal in the amount of revenue recognized will not occur in the future.

Step Three – Determine the Transaction Price

<u>Variable Consideration</u>

- Evaluate whether to "constrain" amounts of variable consideration included in the transaction price
  - Objective of constraint – include all variable considerations in the transaction price only to the extent it is probable that a significant revenue reversal will not occur when uncertainty is subjectively resolved.
- Amount of variable consideration to include in the transaction price should consider both the likelihood and magnitude of a revenue reversal.
  - Penalties, refunds, discounts
  - Claims, change orders, bonus and incentives
  - Could be explicit or implicit
  - Contract price being cut at the end of a project
- Contractor needs to determine (<u>even at the start</u>) all information (historical, current and forecast) to determine contract price.

Step Three – Determine the Transaction Price

<u>Variable Consideration</u>

- An entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts.

- The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and is estimating prices for promised goods and services.

- Allocate Variable Consideration
  - Generally allocate to all performance obligations
  - Allocate to one performance obligation if
    - Terms of the variable payments relate significantly to it
    - Results in reasonable allocation to other performance obligations
    - Cumulative catch-up method

Step Three – Determine the Transaction Price

Variable Consideration

- Variable consideration is accounted for using either:

  - Expected Value Approach
    - Expected amount in a range of values
    - Contractor will evaluate based on prior experience and judgment
    - Only include amounts that have a probable chance of collection

  - Most Likely Amount Approach - "*All or Nothing*"
    - If performance obligation met - receive incentive
    - If not met - receive nothing
    - Can include up to maximum amount expected to be collected based on prior experience and judgment

Step Three – Determine the Transaction Price

Variable Consideration - Penalties

- Contract may contain a penalty if the work is not completed before a specific date. The penalty is considered a variable consideration.

- New standard requires consideration to be estimated as part of the transaction price.

- Factors to consider
  - Does the company have a long history of performing this work on time?
  - Is it within the control of the company to complete the work timely?
  - Will any uncertainty be resolved within a relatively short period of time?

- If the company has a history of incurring penalties, the reduction of the contract price needs to be considered at the inception of the contract.

Step Three – Determine the Transaction Price

<u>Variable Consideration - Incentive Payments</u>

- Example - If the contract terms offer an incentive of $5 million for early completion of a contract, the contractor needs to determine whether it believes it will complete the contract early or not (if incentive achieved, the contractor is awarded $5 million, if not, the contractor receives nothing).

- The amounts are included in the transaction price only if it is probable that a significant reversal of the revenue will not occur in the future.

- Base the determination on past experience with similar contracts.

- It is likely that a contractor will not know whether it will meet the incentive requirements until later on during the contract.

Step Three – Determine the Transaction Price

Practical Consideration

- Each contract must identify any Awards or Penalties.
- Include determination of Awards and Penalties in the “Contract Abstract”.
- Create history of Penalties and Awards by contract type and customer for analysis of “probable”. The practice of either offering a broad range of price concessions or changing payment terms and conditions of similar contracts in similar circumstances.

Step Four- Allocating the Transaction Price

- If more than one performance obligation;
  - allocate the transaction price of each performance obligation based upon an estimate of the ***stand-alone selling price.***
- Stand-alone selling price
  - price an entity would sell a promised good or service to a customer
    - Determined at contract commencement
    - Applied to goods/services based on each separate performance obligation
    - Consider discounts
- The best evidence of a stand-alone selling price would be the observable price for which the entity sells the good or service separately.
  - In the ***absence of separate observable sales***, the stand-alone selling price would ***be estimated***

Step Four- Allocating the Transaction Price

- Example –

A contractor has a contract to build an airport terminal and runway for a contract price of $140 million. If the terminal and the runway are considered separate performance obligations, an estimate of the price of each stand-alone project needs to be determined: $125 million for the terminal and $25 million for the runway, for a total of $150 million on a stand-alone basis. The contract price would be allocated as follows:

- Terminal: ($125M / $150M) * $140M = $116.7M

- Runway: ($25M / $150M) * $140M = $23.3M

Step Five – Recognizing Revenue

- An entity recognizes revenue when a performance obligation is satisfied.
  - <u>Satisfied</u> - transferred a promised good or service to a customer
  - An asset is transferred when the customer obtains ***control of that asset***
- ***Satisfaction of control*** occurs when –
  - The customer has the ability to direct the transferred good or service **AND**
  - The customer receives the benefit of the transferred good or service
- Recognize revenue when the entity <u>satisfies ***each*** performance obligation</u>.
  - Amount recognized = transaction price allocated
  - Satisfied obligation = transferred or customer takes ***control***
  - Can be ***at a point in time or over time***
    - ***At a point in time – typically for transferred goods***
    - ***Over time – typically for transferred service***

Step Five – Recognizing Revenue

- Control is transferred ***over time when at least one*** of the following criteria is met:

  1 - Customer simultaneously ***receives and consumes*** the benefits of the contractor's performance ***as the contract progresses***

  2 - Contractor's performance of a contract ***creates or improves*** the asset ***controlled by the customer***

  3 - An asset with an ***alternative use to the customer*** is not created but the contractor has a right to payment for the performance completed to date

- A performance obligation is <u>satisfied at a point in time if it does not meet the criteria noted above</u>.

Step Five – Recognizing Revenue

- Under the new standard, measuring progress towards completion is performed using one of the following methods:
  - Input method
  - Output method

- Company needs to determine which is the most appropriate regarding performance of the contract.
  - Needs to be consistently applied

Step Five – Recognizing Revenue

- Input method:
  - Recognize revenue on the basis of the contractor's efforts or inputs to the satisfaction of a performance obligation.
  - Examples - labor hours, labor dollars, machine hours, ***costs incurred,*** or material quantities used, relative to the total expected inputs to the satisfaction of that performance obligation.
  - Costs incurred related to rework or wasted materials would be excluded from input measurement, as these costs do not represent the transfer of goods or services to the customer.

Step Five – Recognizing Revenue

- Output method
  - Recognize revenue on the basis of direct measurement of the value to the customer of goods or services transferred to date relative to the remaining goods or services promised under the contract.
  - Examples include: surveys of goods or services transferred to date, appraisals of results achieved, milestones reached, or units produced or delivered.

Step Five – Recognizing Revenue

<u>Certain Cost Recognition</u>

- The new standard identifies certain types of costs that **<u>may</u>** need to be ***capitalized***.
- Incremental costs –
  - These are costs of obtaining a contract that a contractor ***would not have incurred*** if the contract had not been obtained.
  - These costs are recognized as assets if they are ***expected to be recovered*** and are amortized as control of goods or services to which the asset relates is transferred to the customer.
  - If the amortization period is less than one year, these costs may be expensed as incurred (included in job costs).
  - Costs to obtain a contract that would have been ***incurred regardless of whether the contract was obtained*** (e.g. certain bid costs) would be expensed as incurred unless the contract explicitly states they are chargeable to the customer.

Step Five – Recognizing Revenue

Certain Cost Recognition

- Contract fulfillment costs –
  - If not capitalized under other GAAP, fulfillment costs should only be capitalized if the following criteria exist:
    - costs are ***directly related to a specific contract***,
    - costs ***relate to future performance***, **AND**
    - costs are ***recoverable***.
    - Contract fulfillment cost to consider - ***insurance/bonding*** and ***mobilization costs***. Costs are amortized to contract costs as control of the goods or services is transferred.
  - Amortization will most likely be evenly spread over the estimated contract duration.
  - Contract fulfillment costs will need to be considered for impairment.

Step Five – Recognizing Revenue

Certain Cost Recognition

- Exclude costs from the contract that do not contribute to performance.
- When a cost incurred does not contribute to progress in satisfying the performance obligation:
  - Wasted materials
  - Significant inefficiencies in the contractor's performance that were not reflected in the contract price
  - Owner provided materials

Step Five – Recognizing Revenue

Fulfillment Cost

	Contract Price	Estimated Gross Profit	Contract Revenue	Costs incurred to date	Gross Profit	Percent Complete
Existing GAAP	1,000,000	50,000	210,526	200,000	10,526	21.05%
Unamortized Bond				(80,000)		
New Standards	1,000,000	50,000	126,316	120,000	6,316	12.63%

Wasted Cost Recognition / Example

	Contract Price	Estimated Gross Profit	Contract Revenue	Costs incurred to date	Gross Profit	Percent Complete
Existing GAAP	1,000,000	100,000	222,222	200,000	22,222	22.22%
New Standards	1,000,000	110,000	213,483	190,000	23,483	21.35%
Additional exp	-	(10,000)	-	10,000	(10,000)	
	1,000,000	100,000	213,483	200,000	13,483	22.22%

Step Five – Recognizing Revenue

Contract Asset / Liability

- Contractors must recognize a ***contract asset*** if goods and services are delivered to a customer before control is transferred.
    - Similar to: *Cost and estimated gross profit in excess of contract billings*

- Contractors must recognize a ***contract liability*** if customer pays consideration prior to the goods and services being delivered.
    - Similar to: *Billings in excess of cost and estimated gross profit on contracts in process*

Step Five – Recognizing Revenue

Practical Considerations

- Conclusion that the company has an enforceable right to payment for performance completed to date
  - Progress payments could be refundable depending on the terms of the contract
  - Need legal determination for enforceability of right for performance completion to date based on governing jurisdictions
  - Include assessment in “Contract Abstract”
- Cost for work that does not contribute to performance
  - Need to provide education to project team to identify associated costs
  - **Create separate profit center for these costs**
- Create accounting manual for Revenue Recognition and distribute to project and accounting staff
- **Educate project teams**

Balance Sheet

- Accounts receivables
  - Include Retainage if current
  - Unbilled receivables
    - Revenues have been earned but can't be billed until a later dated based on terms of contract – cost reimbursed type contracts
- **Contract Assets**
  - **Unbilled receivables on fixed price contracts are recorded here**
  - **Costs and estimated earnings in Excess of billing on uncompleted contracts**
- **Contract Liabilities**
  - **Billing in excess of costs and estimated earnings in uncompleted contracts**
- Other assets
  - Include Retainage if non-current

Contract costs

- Under current GAAP, pre-contract costs are excluded from jobs and expensed as incurred. Under Topic 606, they are included in job costs. However, such things as materials (whether created specifically for the job or not) and wasted effort (materials *and* labor), must be excluded from the percentage of completion calculation for purposes of recognizing gross profit on jobs. They do get added to costs-to-date when purchased, but no profit is added to the job for these costs.
- This rule has been subject to ongoing scrutiny, and may change before its implementation is required.