# Your Guide to the New Revenue Recognition Standard

Reviewing significant changes & how they could affect your company

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The new revenue recognition standard will significantly affect the way construction businesses traditionally recognize revenue. In most cases, contractors will continue to utilize the percentage of completion method. However, certain items will have a significant impact on the amount and/or timing of revenue recognized. The items that will have the most significant impact under the new standard are the amount of performance obligations that are required to be separated as part of a contract; the contract value, or transaction price, reported based on variable considerations and the related impacts of constraints on those considerations; the actual cost that is reported in calculating percentage of completion; and the disclosures required.

## SINGLE VS. MULTIPLE PERFORMANCE OBLIGATIONS

Under the new standard, an entity is required to determine each contract's performance obligations, or distinct goods and services. Determining if a contract has one or multiple performance obligations hinges on whether the good or service is distinct in the context of a contract. If the good or service is integrated with, highly-dependent on, or significantly modifying or customizing other promised goods or services in a contract, it is considered one performance obligation. We anticipate that many contracts will have a single performance obligation. Based on this premise, the performance obligation needs to be determined at the contract's inception.

## CONTRACT VALUE & TRANSACTION PRICE

The contract value is the total amount of the transaction price of each performance obligation. The transaction price is the amount of each performance obligation a contractor determines will be collected upon completion of the contract, which is done after adjustments are made for any variable considerations and/or amounts payable to a

customer. Examples of variable considerations are awards, incentives, unapproved change orders and claims. Considerations payable-to-customer include costs, such as liquidated damages and back charges. A contractor is required to determine the variable and payable-to-customer considerations each time a financial statement is prepared. The contractor then uses the most likely amount method or the expected value method to calculate the total of each variable payable-to-customer consideration that will impact the transaction price. The most likely amount method should be used when the total is based on a single probable amount of specific outcomes. An example of this would be a contractor receiving a bonus if the project is completed 30 days earlier than the contract requires.

If the contractor believes he/she will complete the project 30 days early, then the bonus should be included in the transaction price. The expected value method is used when there is a range of possible outcomes. An example of this would be with liquidated damages (LDs). A contractor would be required to calculate LDs expected as a result of failure to complete the contract on time. Once the contractor calculates the impact on the transaction price from the variable considerations, the contractor should evaluate the potential constraint on those variable considerations. In order to include variable considerations on the transaction price, the contractor can only recognize an amount of variable consideration with higher than a 75-percent chance that there will not be a significant, variable-related revenue reversal the future.

> In addtion to the potential impact on the timing of the recognition of revenue, there will be new disclosures required under the new standard.

## COSTS INCLUDED IN THE CALCULATION OF PERCENTAGE OF COMPLETION

There are potential significant impacts to the costs that are considered in calculating percentage of completion under the new standard. Items that can carry a significant impact are consideration of uninstalled materials, as well as incurred costs that are not indicative of performance and that do not transfer value.

## UNINSTALLED MATERIALS

In the new standard, there is predominant focus on uninstalled materials, which are goods purchased for a project that have not yet been installed on-site.

If control has not been passed on to the customer, non-distinct, uninstalled materials should be considered inventory until control is passed—even if you have billed the amounts in your latest requisition to the customer. Based on this, contractors could have more amounts included in inventory than expensed on projects, as was the case under the old standards.

## COSTS INCURRED THAT ARE NOT INDICATIVE OF PERFORMANCE

The new guidelines dictate that a contractor can only recognize revenue and gross profit on actual performance. The contractor should only recognize revenue to the extent of the cost incurred on the disproportionate cost items if all of the following are met:

- The good is non-distinct.
- The customer is expected to obtain control of the good significantly before receiving services related to the good.
- The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
- The contractor is procuring the good from a third party and is not significantly involved in designing and manufacturing the good, but the entity is acting as a principal.

An example of a cost incurred that is not indicative of performance is contractor-purchased television sets for a conference room installation. The contractor may not be able to include the cost of the televisions in the calculation of percentage of completion if the cost of the televisions distorts the percentage of completion based on the actual performance. These costs would be a subset of the contract and not included in the calculation of completion. The contractor would be able to recognize revenue to the extent of the additional costs incurred because of these installations, but no profit would be recognized related to these costs.

## COSTS INCURRED THAT DO NOT TRANSFER VALUE

The new standard focuses on the transfer of goods and services to the customer and does not allow for the recognition of revenue on costs that do not provide value to a customer. These costs include, but are not limited to: mobilization to a jobsite, surety bonds and administrative costs to setup a project. The costs incurred that do not transfer value to a customer would be removed from the cost incurred on the project and amortized over the life of the project. An example of this would be a $1 million-mobilization cost on a 2-year project. The cost of mobilization would be placed on the balance sheet as a contract asset and amortized on a monthly basis over the 2 years of the contract at $41,667 per month. This scenario depicts the significant impact on contractors who incur costs that do not transfer value to customers.

## DISCLOSURE

In addition to the potential impact on the timing of the recognition of revenue, there will be additional disclosures required under the new standard. Required disclosures under the new standard include the following examples:

- Method of transition to the new standard (full retrospective versus modified retrospective)
- Aspects of revenue and cash flows from customer contracts, including the nature, amount, timing and uncertainty of the revenue recognized
- Details related to the contract assets and liabilities and the changes in those balances
- Details of performance obligations related to the types of goods and services, significant payment terms and typical timing of satisfying obligations
- Quantitative disclosure of the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially satisfied)" and when the entity expects to recognize that amount as revenue
- Significant judgements and changes in those judgements that affect the amount and timing of revenue recognition
- Cost to obtain or fulfill a contract
- Policy decisions

Calendar year, non-public entities begin to report under the new standard December 2019, giving contractors ample time to understand the new standard and its impact on revenue recognition and progress tracking for their long-term construction contracts. It is highly recommended that contractors start implementing procedures to capture the information required to address issues certain to present themselves once the new standard rolls out.

Contractors should employ accountants who are familiar with and educated on the new standard and its inevitable impact on the construction industry. **CBO**

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