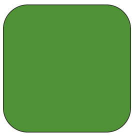

NUTS AND BOLTS OF THE NEW REVENUE RECOGNITION STANDARDS FOR E&C ENTITIES

Topic 606 will have a significant impact on the way E&C entities recognize revenue from contracts.

ROBERT MERCADO AND JAMES MILLER

The accounting world is beginning to change how entities globally recognize revenue. Federal Accounting Standards Board Accounting Standards Codification 606, *Revenue from Contracts with Customers* (Topic 606) is designed to have all entities recognize revenue universally.[1] Many industries, including engineering and construction (E&C), currently recognize revenue based on an industry-specific methodology.

Rules take effect

Public entities that have an annual reporting period beginning on or after December 15, 2017, (including interim periods within that reporting period) will begin

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implementing this rule. Topic 606 will be effective for all other entities that report annually with the annual period beginning after December 15, 2018, with interim reporting periods reported under the old rules until the annual period reported under the new rule.

Full retrospective versus modified retrospective

Two methods are available when adopting the new standard: full retrospective and modified retrospective. It is likely the full retrospective method will be utilized by many large public companies, requiring entities to restate comparative prior periods presented in current year financial statements.

Most privately held entities, including within the E&C industry, will favor the modified retrospective method. This allows entities to report revenues for the transition year under the new standard. If an entity chooses to present comparative financial statements, the prior year financial information will remain under the old method. Entities are required to provide a disclosure that outlines how the financial statements would have looked under the old standards to facilitate comparison between the years.

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) core principle

The core principle of the FASB and the IASB was for entities to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The FASB and IASB came up with the following five steps:

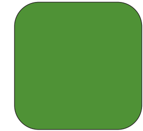
1. identify contract(s) with a customer;
2. identify performance obligations in the contract;
3. determine transaction price;
4. allocate transaction price to the performance obligations; and
5. recognize revenue when (or as) each performance obligation is satisfied.

Step 1: Identify the contract(s) with a customer

Entities shall account for a contract with a customer when all of the following criteria are met:

- the parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations;
- the entity can identify each party's rights regarding the goods or services to be transferred;
- the entity can identify the payment terms for the goods or services to be transferred;
- the contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract); and
- it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.

One item of concern is the section of Topic 606 that states, "a contract does not exist if each party to the contract has a unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties)." A contract with a termination for convenience clause is a service contract, not a long-term contract. We anticipate a change to this language that will allow E&C contracts with this clause to continue as long-term contracts versus



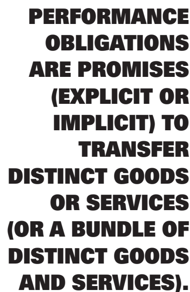
TWO METHODS ARE AVAILABLE WHEN ADOPTING THE NEW STANDARD: FULL RETROSPECTIVE AND MODIFIED RETROSPECTIVE.

service contracts. The E&C Revenue Recognition Task Force of the American Institute of CPAs (AICPA) has requested the FASB change certain language regarding this termination clause.

Step 2: Identify the performance obligations in the contract

Performance obligations are promises (explicit or implicit) to transfer distinct goods or services (or a bundle of distinct goods and services).

At the inception of a contract, an entity is required to determine the various performance obligations that comprise the contract. Each obligation within the contract can be treated as a separate contract for accounting purposes. Often the E&C industry views contracts with a customer as an entire performance obligation, except in certain circumstances (such as a contract to build and maintain a facility). There are two steps to consider while explaining this concept. The first step is determining whether the good or service is capable of being distinct. Can a customer benefit from the individual good or service on its own or use the good or service with other readily available resources? An entity hired to perform design services, followed by the construction of that designed project, would consider this contract to be one performance obligation. Based on the first step, an argument could be made that two performance obligations exist, one to design and one to build. Is the good or service distinct in the context of the contract, meaning is the good or service integrated with, highly dependent on, highly interrelated with, or significantly modifying or customizing other promised goods or services in the contract?



PERFORMANCE OBLIGATIONS ARE PROMISES (EXPLICIT OR IMPLICIT) TO TRANSFER DISTINCT GOODS OR SERVICES (OR A BUNDLE OF DISTINCT GOODS AND SERVICES).

Highly dependent and interrelated. Those who perform design/build contracts understand the design phase does not end once the construction phase has begun. The construction phase is highly dependent, highly interrelated, and could be significantly impacted by the design phase throughout the project. The AICPA's E&C Revenue Recognition Task Force focused on this concept to determine the performance obligations in an E&C contract. The AICPA's E&C Revenue Recognition Task Force and the FASB concluded that in this situation, a design/build contract is one performance obligation. Each contract an entity enters needs to be evaluated to determine the performance obligations. What if a glass contractor was awarded a single contract to install the glass in multiple buildings for the same customer? Each individual building could be a separate performance obligation. Is the glass installation in each building integrated with, highly dependent on, highly interrelated with, or significantly modifying or customizing other promised goods or services in the contract? The contract with the customer would be determined to constitute multiple performance obligations in the accounting records of the entity. In some E&C contracts, operation and/or maintenance of a facility is included. The operation and maintenance is often a separate performance obligation. An activity that is performed to satisfy an obligation that does not transfer a good or service to a customer can never be counted as a performance obligation (i.e., administrative tasks and mobilization costs).

Combining versus segmenting. If all of the following apply, multiple contracts would be combined into one contract:

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; and
- the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation.

Warranties. Assurance type warranties are part of the required product the entity is delivering. An assurance warranty is not a separate performance obligation. However, a service type warranty is a separate performance obligation. The warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that was initially contracted.

An entity should account for the promised warranty as a performance obligation, allocating a portion of the transaction price to that performance obligation on a service type warranty. If an entity provides on a contract both an assurance and service type warranty, the entity would need to determine a distinct price for the service type warranty. If the entity were unable to do so, a separate performance obligation that includes both the assurance type and service type warranties would be necessary.

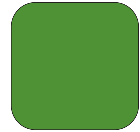
Step 3: Determining the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for the transfer of promised goods or services to a customer. The transaction price includes the effects of the following:

- variable considerations (including application of the constraint);
- consideration payable to a customer;
- noncash considerations; and
- significant financing components.

We do not anticipate impacts to the E&C industry for significant financing activities. Retainage is excluded from the significant financing components. The only addressable item in this area is if the entity overbills an amount to the customer that does not become revenue within a year.

Variable consideration (including application of the constraint) and consideration payable to a customer. Variable consideration can be items such as awards and incentives for completing a contract ahead of schedule or under budget. There could be consideration payable to a customer such as liquidated damages (LDs). These types of items are an increase or decrease to the transaction price/contract value in the most likely amount or the expected value. The most likely amount would be the amount based on the single most probable amount in a range of possible outcomes. The most likely amount is used when the transaction will produce only a few possible outcomes. For example, the entity may get a bonus of $500,000 if the entity substantially completes the project for the customer 30 days prior to the contract completion date. If the entity does not complete the contract 30 days or more prior to such date, the entity is not entitled to any bonus. There are two possible outcomes in this example. The entity needs to evaluate the likelihood of receiving the bonus. If the entity is confident that they could earn the bonus, the transaction price/contract value increases by $500,000. If not, the transaction price does not include any bonus. The expected value method is used when there is a range of possible outcomes (for example, LDs). An entity could enter into a contract that states the entity is subject to LDs if the project is not substantially completed by a certain date, with LDs calculated daily. This calculation would result in a range of possible outcomes. The entity would be required to calculate the amount it expects to incur in LDs resulting from being late. The most common response is to not expect to pay any LDs and not expect to be late. However, if the entity has ever been late on a project, it cannot take the position that it will not be late on a future project.



THE TRANSACTION PRICE IS THE AMOUNT OF CONSIDERATION TO WHICH AN ENTITY EXPECTS TO BE ENTITLED IN EXCHANGE FOR THE TRANSFER OF PROMISED GOODS OR SERVICES TO A CUSTOMER.

Evaluation of a constraint. Included in the effect of variable consideration is the evaluation of a constraint on the amount included in the transaction price. The entity is required to include in the transaction price an amount of variable consideration that makes it sufficiently probable a significant revenue reversal will not occur when the uncertainty is subsequently resolved. An example of variable consideration with a potential constraint is a claim. A claim is an unapproved change order for scope and price. Under Topic 606, a claim is considered variable consideration. This is a major change from how we have assessed claims under the old standards. Previously, four specific criteria had to be met prior to determining the amount the entity would recognize as revenue related to the claim. Entities were restricted from recognizing profit on a claim; revenue could only be recognized to the extent of cost. Under Topic 606, the entity is able to recognize revenue and profit on a claim, as long as

EXHIBIT 1 Expected Value Method Calculation

$1,000 × 15 days late = $15,000 × 30% probability =	$ 4,000
$1,000 × 30 days late = $30,000 × 45% probability =	$13,500
$1,000 × 45 days late = $45,000 × 25% probability =	$11,250
	$29,250

it is probable that a significant reversal of the revenue recognized on that claim will not happen in the future. When assessing this probability, it is important to understand considerable factors. Under Topic 606, factors that could impact a revenue reversal include, but are not limited to, any of the following:

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

The following is an example of a contract with LDs and the application of a constraint. Company A enters into an $8 million contract to build a structure. The contract states that Company A will be assessed LDs of $1,000 per day for each day the project is late after August 31 of a given year. Upon entering into the contract, Company A is required to calculate the impact on the transaction price associated with the LDs. Company A used the expected value method calculation, as shown in Exhibit 1.

Based on the total in Exhibit 1, Company A anticipates a decrease to the transaction price of $29,250. Company A applies the constraint on the aforementioned calculation. Based on the previously stated probability, Company A could be late by 30 days (75 percent likelihood). Company A would compare the amount calculated ($29,250) to the amount probable ($30,000). Based on this calculation, the constraint provides an immaterial adjustment and is not required. The transaction price would be $7,970,750 ($8 million contract value less $29,250).

Noncash considerations. Noncash consideration are goods or services provided by a customer to an entity. It must be determined whether an entity takes possession of a good or service (asset) prior to delivering the asset to a customer. This concept addresses principal versus agent. A principal takes ownership of the asset prior to turning over the asset, such as a general contractor that is at risk on a contract. An agent does not take ownership of an asset prior to turning over the asset, such as a construction manager not at risk on a contract. The construction manager not at risk enters into a contract on behalf of the customer with subcontractors and suppliers but ultimately does not take ownership of the work performed by the subcontractors and items provided by suppliers. The subcontracting and supplier costs are noncash considerations. A contractor, acting as an agent, would only record the agent's fee associated with the contract, excluding considerations provided by the customer.

Reassessment of transaction price. An entity should reassess the transaction price on a regular basis but is required to do so each time a financial statement is prepared.

Step 4: Allocate the transaction price to the performance obligations

Once performance obligations on a specific contract are identified, allocating a transaction price for each obligation must be completed. An entity's role during pricing allocation involves the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. The transaction price for each performance obligation should be assigned based on the stand-alone selling price or estimated based on a rational method for estimating each transaction price for the multiple performance obligations. The rational method of estimating the transaction price for each performance obligation will consider the observable inputs that each of the performance obligations involves. One favorable strategy we suspect many entities will choose is an estimated cost plus a markup method. The transaction price for a performance obligation is modified based on which performance obligation is affected by a variable consideration.

Once a transaction price is allocated to a particular performance obligation, that price should not be changed unless either a contract modifies or a change in the estimate of variable consideration occurs.

Step 5: Recognize the revenue when (or as) each performance obligation is satisfied

The satisfaction of a performance obligation is the transferring of a promised good or service (asset) to a customer. An asset is transferred once the customer obtains control. At contract inception, an entity determines whether performance obligations are satisfied over time or at a point in time. In order to determine the timing of revenue recognition, identifying when the control of a good or service is transferred to the customer is paramount. For revenue recognized over time (i.e., percentage of completion), the transfer of control of the goods and services must meet one of the following three criteria:

- the entity creates or enhances an asset that the customer controls as it is created or enhanced;
- the entity's performance does not create an asset with alternative use, and the entity has a right to payment for the performance completed to date; or
- the customer simultaneously receives and consumes the benefit of the entity's performance as the entity performs.

Output versus input methods

If revenue will be recognized over time, the entity decides whether the output or input method will be used for the measurement of revenue recognized. Output methods include surveys of performance completed to date, appraisals of results achieved, milestones reached, units produced, or units delivered. Input methods include resources consumed, labor hours expended, costs incurred, time lapsed, or machine hours used relative to the total expected inputs to the satisfaction of that performance obligation.

IF AN ENTITY INCURS SIGNIFICANT INEFFICIENCIES IN PERFORMANCE ON A CONTRACT, THAT ENTITY IS REQUIRED TO REMOVE THESE COSTS FROM A CONTRACT AND EXPENSE THE COST AS INCURRED.

Significant inefficiencies in performance

If an entity incurs significant inefficiencies in performance on a contract, that entity is required to remove these costs from a contract and expense the cost as incurred. This transaction is significant due to the potential impact on the entity's financial statements. Under the old standard, if an entity incurred additional cost on a project for overruns or inefficiencies, it was required to include such costs in the total estimated cost of a contract. This resulted in a profit fade and a current year impact of that fade. Under the new standard, cost that is determined to be the result of significant inefficiencies in performance would not be included in the estimated cost of the project and cost incurred to date. The cost would be expensed as incurred; this expense affects the current year financial statements dollar for dollar.

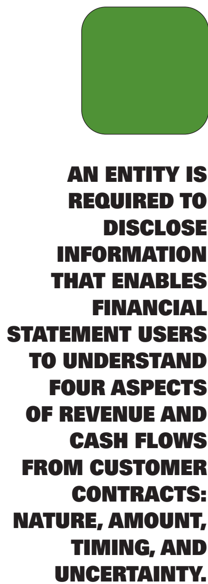
Uninstalled materials

Uninstalled materials are goods purchased for a project not yet installed on

the project. Identifying the accounting treatment for uninstalled materials is based on whether control has passed to the customer. If not, uninstalled materials that are not distinct are considered inventory until control is passed.

If control has passed but the cost incurred is not proportionate to the entity's progress in satisfying the performance obligation, the input method would have to be adjusted to recognize revenue only to the extent of the cost incurred on the uninstalled materials. Entities should exclude from an input method the effects of any input that does not depict the entity's performance in transferring control of those goods or services to a customer. In this situation, if all of the following criteria are met, the entity should only recognize revenue to the extent of the cost incurred on the nonproportionate cost items:

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



When materials originally accounted as uninstalled materials are installed, the entity would be required to determine the most appropriate accounting treatment for those materials. Should materials be included in the calculation of the percentage complete at any point, if ever, on the project, or should the actual percentage complete be based on the performance of the entity? Materials might be accounted for as a separate subset of the project with revenue equaling cost through the completion of the project, while the main contract would recognize the gross profit based on the percentage complete excluding the cost of the materials in the separate subset. If materials on the project that are recognized relate to the actual performance of the entity's percentage complete, the entity would need to do a cumulative catch-up adjustment for the gross profit on the project for the period in which the materials are included in the cost-to-cost calculation.

Cost incurred that does not transfer value

When an entity incurs cost that does not provide value to the customer, it cannot recognize revenue related to this cost. For example, mobilization of equipment to a site by a site contractor does not equate value to the customer. Based on this, the site contractor would not be able to recognize revenue associated with the cost incurred for mobilization. The cost would be removed from the cost incurred on the project and amortized over the life of the contract. These costs include, but are not limited to, bond cost, mobilization, and contract start-up administrative costs.

Retainage

Topic 606 requires retainage held by a customer recorded on the balance sheet as a contract asset if the payment of the retainage is contingent upon additional performance by the entity and/or acceptance by the customer. Retainage will be reclassified from a contract asset to a receivable when it is conditional based upon the passage of time.

Disclosure requirements

An entity is required to disclose information that enables financial statement users to understand four aspects of revenue and cash flows from customer contracts: nature, amount, timing, and uncertainty.

These disclosure requirements include the following:

1. presentation or disclosure of revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts;
2. a disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue

and cash flows are affected by economic factors";
3. information about:
   - contract assets and contract liabilities (including changes in those balances);
   - the amount of revenue recognized in the current period that was previously recognized as a contract liability; and
   - the amount of revenue recognized in the current period that is related to performance obligations satisfied in the prior periods;
4. information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions);
5. information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) a 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;
6. a description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations);
7. information about the entity's accounting or cost to obtain or fulfill a contract (including account balances and amortization methods); and
8. information about policy decisions (i.e., whether the entity used the practical expedients for significant financing components and contract costs allowed by Topic 606).

Conclusion

Topic 606 will have a significant impact on the way E&C entities recognize revenue from contracts. E&C entities need to determine the effect this will have on the way information is analyzed and reported and formulate an action plan to be ready in advance. How prepared are you? ■

NOTES

[1] FASB ASC 606, *Revenue from Contracts with Customers*. Available at: https://asc.fasb.org/imageRoot/32/79982032.pdf.